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CONSIDERATION OF THE COUNTRY PRESENTATIONS IN THE LIGHT OF A CROSS-COUNTRY REVIEW BY THE SECRETARIAT OF THE DESIGN, IMPLEMENTATION AND RESULTS OF PRIVATIZATION PROGRAMMES

Design, implementation and results of privatization programmes: a cross-country review of national experiences

Report by the UNCTAD secretariat

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CONTENTS

	Paragraphs
INTRODUCTION	1 - 4
I. OBJECTIVES OF PRIVATIZATION AND RELATED ISSUES	5 - 35
A. Objectives	5 - 9
B. Strategy for privatization	10 - 19
C. Resolution of conflicts of objectives	20 - 23
D. The role of social objectives	24 - 29
E. Relationship to other enterprise reforms	30 - 35
II. MACROECONOMIC CONSIDERATIONS	36 - 42
III. THE ROLE OF THE STATE	43 - 66
A. Changing roles of the public and private sectors	43 - 51
B. Institutional changes	52 - 54
C. Competition and regulation	55 - 66
IV. TECHNICAL, LEGAL, FINANCIAL AND OTHER ISSUES	67 - 126
A. Legal issues	67 - 71
B. Criteria for selection of enterprises for privatization	72 - 73
C. Methods and sequencing of privatization: sale and transfer techniques	74 - 91
1. Privatization of capital	75 - 84
2. Privatization of management	85 - 88
3. Privatization of infrastructure	89 - 95
4. Contracting out of public services	96
5. Particular conditions attached to privatizations	97 - 98
D. Privatization plans	99 - 100
E. Organization of privatization	101 - 105
F. Information, promotion and marketing techniques	106 - 111
G. Financing of privatization	112 - 119
H. Role of multilateral institutions and bilateral donors	120 - 122
I. Environmental issues	123 - 126
V. SOCIAL IMPACT	127 - 137
A. Social effects	127 - 130
B. Socially-related support measures	131 - 137
VI. RESULTS OF PRIVATIZATION AND THEIR EVALUATION	138 - 146
A. Assessment of results	138 - 140
B. Results of privatization	141 - 146

INTRODUCTION

1. This report has been prepared at the request of the Ad Hoc Working Group in connection with its review of country experiences (item 3 of the provisional agenda for its fourth session). It is a further revision of the document (TD/B/WG.3/7/Rev.1) submitted to the third session of the Ad Hoc Working Group in the light of the discussions that took place at that session, particularly on (1) competition and the regulation of privatized monopolies and (2) social impact of privatization and socially-related support measures.

2. In addition to the discussions which have taken place in the Ad Hoc Working Group at its first to third session, this report draws on the country presentations and statements of national experts submitted to the Ad Hoc Working Group from the following countries: Argentina, Australia, Bulgaria, Brazil, Canada, China, Colombia, Czech Republic, Egypt, Finland, France, Germany, Ghana, Greece, Hungary, Indonesia, Israel, Jamaica, Japan, Jordan, Lithuania, Malaysia, Morocco, the Netherlands, New Zealand, Niger, Nigeria, Pakistan, Peru, the Philippines, Poland, Portugal, Republic of Korea, Romania, Russian Federation, Senegal, Slovakia, Slovenia, Sri Lanka, Sweden, Thailand, Tunisia, Turkey, United Republic of Tanzania, United Kingdom, United States of America and Venezuela. Some examples from other country experiences have also been added for illustrative purposes.

3. This report is organized according to the structure of the work programme of the Ad Hoc Working Group adopted by it at its first session. It attempts to compare and synthesize the different elements contained in the country experiences with privatization, as described in the country submissions. It reflects the varying quality and quantity of the information provided, as well as the diversity of country experiences reflected, in them. Under each topic, a short statement of the issues raised by the country experiences and of related policy conclusions is provided, and illustrative examples are given showing how the issues have been or are being addressed. Since this is an exercise based on a comparison of experiences, every effort has been made to let the experiences "speak" for themselves. However, because of the wealth of material contained in the submissions and because some selectivity is needed, this paper cannot do full justice to it. In selecting certain illustrative examples in order to keep this paper within a reasonable length, every attempt has been made to choose examples which are interesting, different and useful and which at the same time reflect the widest possible range of situations among the countries concerned.

4. Two issues that were raised at the third session, namely (1) privatization and the environment, for which a paper was submitted by Norway, and (2) the privatization of pension funds, are treated separately in an addendum to this report.

I. OBJECTIVES OF PRIVATIZATION AND RELATED ISSUES

A. Objectives

5. While the objectives cited by Governments for their privatization programmes contain some common elements, they also contain differences in emphasis or orientation, reflecting different country situations and priorities. These differences are reflected in the wide variety of objectives enumerated below. While many of them are no doubt of more general applicability, some others may be country-specific.

6. The primary objective shared broadly by Governments is to promote economic efficiency. For the developing countries, there is another major objective, which is to reinvigorate, modernize and internationalize the economy, with all that the achievement of such an objective implies in terms of the changing roles of the State and the private sector. For the countries in transition of Eastern and Central Europe and of the former Soviet Union, in addition to the efficiency objective, there is a fundamental objective, which is to transform the economy from a planned to a market-oriented system by promoting structural change and building up the institutional framework of a modern market economy, with the private sector playing a key role in the transformation process. Another broadly-shared objective of Governments is to extend the benefits of economic growth to all sections of the population.

7. Within these general objectives, more specific objectives or, for some, the means to achieve them, are indicated by the countries concerned. These are, under the rubric of enhancing efficiency, to promote competition and the efficient allocation of resources; and to improve the performance, efficiency and competitiveness of enterprises or of productive sectors. The "institutional" objectives (which are also to promote efficiency) relating to institutional building or improvement for the transformation, modernization or internationalization of the economy are: to develop a strong private sector as the engine of growth; to accelerate market development; to strengthen entrepreneurial and managerial capacity; to improve the performance and profitability of public enterprises (PEs) by subjecting them to the discipline of private sector or market principles, including the raising of risk capital in capital markets; to promote an effective system of corporate governance; to strengthen financial markets and institutions; to create a climate for increased private investment, both domestic and foreign, including investment in infrastructural facilities, and to secure enhanced access to foreign markets, new technology and advanced business skills; and to facilitate a partnership between domestic and foreign private sector operators.

8. Those relating to the role of the Government and macroeconomic management include: to preserve the national patrimony; to reduce the role of the State in the economy (and thus to redistribute the functions between the public and private sectors); to reduce the administrative burden on the State, so that it can use its management resources in an optimal fashion and concentrate on running the vital business of Government and on providing a favourable environment for private sector development; to reorient industrial policy; to improve and secure fiscal balance by reducing the financial burden of PEs on the budget and/or by increasing Government revenue; to remove or reduce commercial risks related to PEs from the Government's balance sheet; to secure

additional sources of financing for development activities due to budgetary constraints; to reduce internal and external debt, including through the use of debt-equity swaps; and to improve and protect the environment.

9. Those relating to the distributional objective of extending the benefits of economic growth to all sections of society include: to widen and deepen share ownership (and, through it, to widen and deepen capital markets); to broaden or democratize the ownership and control of productive sectors (or to protect "key industries" from being monopolized by a few); to promote decentralization, regional or rural development; to increase employment by improving the basis for long-term job creation; to generate funds for social safety net measures; to improve social and public services; and to improve the standards of living of citizens.

B. Strategy for privatization

10. Privatization is part of a process of structural adjustment. It involves redefining the role of the State by disengaging the State from those activities which are best done by the private sector, with the overall objective of achieving economic efficiency. It is first and foremost a political process, although it has to be carried out as an economic exercise. Privatization may involve: (a) non-divestiture options - commercialization, corporatization, privatization of management (management contracts, leasing and concessions) and the contracting out of public services; and (b) divestiture options - privatization of capital. Privatization may be sequenced by going from non-divestiture (for example, corporatization or management privatization) to divestiture options.

11. Thus, privatization implies fundamental change in the role of the State in relation to the promotion of industrialization, the creation of employment and the provision of infrastructure or social services. Various sections of society are affected by this change: workers and managers of PEs; bureaucrats, for many of whom such enterprises are a power base and a source of patronage; politicians; and consumers. They will have to be convinced of the value of privatization if a broad-based consensus is to be achieved. Further, the divestiture of PEs normally involves sales to foreign investors; if such sales are on a large scale or if they lead to abuses because of insufficient safeguards, there is a risk of a political backlash. Moreover, if privatization takes place under unfavourable conditions, with adverse consequences, including unsuccessful sales or failed privatized enterprises, then its very credibility will be affected. For all these reasons, a strategy is needed that will address these matters. The strategy can also include elements to enhance the results of privatization, for example, effective marketing in order to enhance the value of assets to be sold and thus to maximize the revenue from privatization. For it to be effective, it will need to be part of an economic strategy which facilitates structural change and which is capable of cushioning any disruptive effects of privatization.

12. Such a strategy will need to include a number of elements. One, because privatization is first and foremost a political process, the strategy will need to define the extent of privatization, the objectives to be achieved, including social objectives, and the guidelines and procedures to be used for implementation. Among such procedures are those relating to the promotion of

transparency and of the value of privatization to all the parties concerned in order to build up a broad-based consensus. Two, privatization entails the substitution of a private sector for a public sector culture; in the former, investment and commercial risks are assumed by the enterprise, while in the latter such risks are ultimately assumed by the State. In cases where public utilities or major public enterprises are involved, the sequencing of commercialization or corporatization to divestiture may be necessary in order to allow the private sector culture to take hold and to turn round the public enterprises before they are transferred to the private sector.

13. Three, effective marketing can help to add real value to an enterprise to be sold and will need to be consistently carried out. Four, the selling techniques will need to combine the objective of "popular capitalism" with the need to ensure effective corporate governance. Five, techniques will have to be adapted to take account of the objectives and of the different kinds of enterprises (by size, financial status, etc.) to be privatized so as to implement the privatization programme effectively and at least cost. For example, if the PEs are small ones and the objective is to achieve quick-low cost sales, then public auctions may be used. It should be remembered that privatization transactions, particularly those involving public flotations, are costly exercises. Six, safeguards will have to be provided in order to prevent abuses, including guarantees written into sales contracts or the use of a "golden share" where important public interests are involved, as in the case of public utilities. Seven, adequate regulatory capacity in terms of laws and institutions will need to be established or strengthened for the regulation of privatized monopolies. Eight, the role and extent of foreign participation will need to be defined, particularly for public utilities and large-scale enterprises (LSEs) in order to avoid political complications regarding foreign ownership, although such complications do not normally arise for small and medium-sized enterprises (SMEs). Nine, some kind of monitoring procedure will need to be established in order to monitor compliance with commitments made, for example concerning investment or employment, and the results of privatization, including efficiency gains achieved and their translation into tangible benefits for consumers and for the economy. This is particularly important for privatized public utilities. And finally, arrangements will have to be made for putting in place properly-designed social compensation measures for retrenched workers, as well as services and mechanisms to improve skills, encourage labour mobility and facilitate job creation through enterprise development.

14. In practice, the nature of the strategy may be influenced by the size of the public sector and the resulting pressures on the pace of privatization. Thus, the need for reducing the public sector and for building up a private sector rapidly as the instrument of economic transformation, and the necessary institutional structure of a market economy, may call for a multi- and a fast-track approach. In Poland, for example, privatization has to take place within a democratic political framework ensuring the support of society as a whole and of company employees claiming the right to collective ownership in particular. It has had to be carried out on a number of levels: transformation of ownership, establishment of the legal and institutional framework, organization of political activities and creation of individual consciousness. The strategy envisages a multi-track approach, involving mass privatization (to cover 600 large and medium-sized PEs), corporatization of PEs followed by

the sale of their shares to private investors, and liquidation followed by the sale of their assets, their transfer or leasing in parts or in whole to other companies. The strategy also allows for the rapid (fast-track) sale of PEs in their entirety when the legal ownership of land and other fixed assets under their control is established. Separate privatization paths are envisaged for the various categories of PEs concerned (State, municipal, cooperative-owned, private or semi-private and joint ventures), often with the simultaneous use of different techniques within each category. Further, twenty sectoral studies, including market analyses and perspectives of particular industrial sectors, are being undertaken to help the choice of strategy and method. To support the process, the Government has signed a tripartite pact with employers and workers. Under this pact, workers have the right to decide on the form of privatization over a six-month period: however, if they fail to make a proposal, the Ministry of Privatization has a free hand to do so.

15. On the other hand, in countries where such pressures do not exist, a more gradual approach is considered important, for example, for ensuring success without negative effects (as in Morocco); for promoting entrepreneurial development (Portugal); or for converting PEs through commercialization and corporatization into commercially-run and stand-alone enterprises and turning them round before they are transferred to the private sector (the Netherlands).

16. Commercialization involves the reorganization of a PE and the introduction of commercial principles into its operations, including the application of user charges, commercial accounting and commercial performance objectives, with the aim of turning it into a commercially-viable and profit-making enterprise. Commercialization has been used extensively in Nigeria, where the commercialized enterprises are required to function commercially without Government subsidies. A crucial element is a Performance Agreement between the Government and the enterprise, in which the company management commits itself to the attainment of certain performance objectives in return for operational autonomy. It has also been used in other countries as a preparatory step to corporatization (as in Malaysia). Sometimes the terms "commercialization" and "corporatization" are used interchangeably; however, a distinction needs to be made between "commercialization" involving the conversion of a PE into a separate entity under statutory law and "corporatization" involving the conversion of a PE into a joint stock company (for LSEs) or limited liability company (for SMEs) under company legislation. To the extent that the commercial and investment risks are not fully transferred to the private sector, such reforms are not seen as privatization in the strict sense of the word.

17. The passage of PEs through corporatization has been an important aspect of privatization strategy in a number of countries, including Australia, Finland, France, Malaysia, the Netherlands and New Zealand. Corporatized enterprises are required to operate as stand-alone commercially-run corporations. While the Government may require that certain social objectives be pursued and explicitly pay for them (as in New Zealand), they are required to pursue commercial objectives alone and to maximize their profits and net worth. Corporatization has, in fact, been used successfully in respect of public utilities or large-scale PEs in these countries to restructure a PE,

put it on a sound financial footing and to enhance its sales value before transferring it to the private sector.

18. In Morocco, the strategy for privatization has a number of elements: to create confidence and credibility in the process by public education and a promotional campaign and by focusing on public enterprises which are profitable or potentially profitable, which already have a legal corporate status, which have a major economic role without an important public service role, and which are already subject to competition; to build worker confidence in privatization and to maintain a social climate that favours investment and growth by choosing privatizables without major overstaffing problems; to build investors' confidence by the abrogation of the Morocconization provisions of the 1970s, by practising fair pricing and by promoting transparency in the valuations and organizations of privatization projects; and to promote regional development and decentralization of shareholding (to complement the overall movement to decentralization) by including PEs which have a regionally diversified base.

19. In Côte d'Ivoire, after a first phase of divestitures involving 22 enterprises in the 1980s, characterized by several shortcomings, the Government in 1990 developed a strategy which helped to improve the design and implementation of the current privatization programme covering 54 PEs. Among other things, sales, rather than being ad hoc, have been part of a broad plan and guidelines and clear procedures have been established. Criteria have been established for choosing PEs for privatization, favouring those enterprises where privatization would boost their production, attract private investment for growth or generate financial resources for the State. Guidelines have been established for dealing with PEs facing severe financial problems and for achieving the State's total disengagement from certain sectors such as transport, tourism and agro-industry.

C. Resolution of conflicts of objectives

20. The process of privatization implies the need to clarify and balance different objectives which may sometimes be in conflict with each other. For example, the objective of raising maximum revenue from sales may conflict with the objective of promoting efficiency gains if, for example, monopolies are sold without regulatory or other measures to prevent abuse of monopoly power. The financial objective may also conflict with the social objective of protecting or generating jobs if priority is given only to revenue maximization without concern for future investment by privatized companies. If speed of implementation is the objective, valuation may be simplified, for example by using the book value which may diverge significantly from the real value, and various techniques, including negotiated sales without competitive bidding and internal privatizations like management and employee buy-outs (MBOs, EBOs), may be used. However, this may conflict with the objectives of efficiency, equity, transparency and of mass privatization. Public flotations may increase political and social acceptability and promote transparency, but they can slow down the pace or increase the cost of the process.

21. Further, the objective of promoting wide share ownership may conflict with the objective of promoting good corporate governance or dynamic enterprise development. For example, in Portugal, the concern has been

expressed that, where stock markets are not well developed, thereby making it difficult to separate ownership from management, wide share ownership may conflict with the objective of reinforcing the vitality of firms and of entrepreneurship. The need to ensure the stability of capital of a privatized firm, the infusion of new capital or good corporate governance has led to various measures being adopted. Thus, wide share ownership by the price targeting of small investors is combined with the sale of blocks of shares to a core of institutional long-term investors, e.g. banks and insurance companies (as in France) or to a core corporate investor (Sri Lanka). Incentives (e.g. free bonus shares) to encourage small portfolios to retain their shares for a specified period are also used (France, United Kingdom). In Morocco, a 15 per cent discount is given on the share price to employees if the shares are kept for three years. A certain stability of small portfolios has been recorded (France). For the purpose of protecting the privatized firms from the volatility of the shareholdings of international institutional investors and for other public policy objectives, certain countries limit foreign participation in the equity of privatized companies (for example, Malaysia, 25 per cent; France, 20 per cent, but not applicable to EC nationals since 1993).

22. The question has been raised as to whether a rather demanding social plan to safeguard employment, such as the one used in Malaysia for its privatization projects, may involve a trade-off in terms of a lower sales price and therefore of reduced revenue. The question may also be raised concerning the business or industry development plan, including the scale of proposed investment and often a social plan, which potential investors have to provide in connection with their bids to buy firms (as in Australia, Ghana, Germany, Lithuania, Poland and Senegal). However, the choice between a good price, on the one hand, and a good business plan with important social safeguards, on the other, may be a false one; new investment generating growth and employment, as well as social stability in the long run, may compensate for temporary reductions in revenue. Some of the new investments can be considerable. In Sri Lanka, one of the first privatizations fetched US$ 22 million in investment, allowing the company not only to absorb the surplus labour but also to add 1,200 new jobs to the existing payroll of 3,000 employees within two years. In Peru, an iron ore company was auctioned for US$ 120 million to a foreign company, which committed an investment of $ 150 million over a three-year period. A copper deposit in the same country was auctioned for $12 million to another foreign company, which is expected to invest $560 million to fully develop the mine. In Lithuania, in considering bids, a good business plan, together with a social package, is in fact rated higher than the offer price.

23. In Lithuania, during the preparation of the programme, a conflict arose between commercial and distributional objectives. Those in favour of the former argued that only commercial privatization could provide efficient private owners. Those who favoured voucher or mass privatization argued that, in view of the limited private investment possibilities, commercial privatization would take a very long time and that the inefficiency of PEs would not be compensated by the efficiency of a small number of private firms, that such privatization would concentrate ownership in the wrong hands (the former nomenclature) and that the State must compensate for low wages paid

under past policies and practices. The latter had wide popular support and Parliament has adopted it as the main principle of the privatization programme.

D. The role of social objectives

24. The importance attached to social objectives is reflected in their influence on the design and implementation of privatization programmes, including their "social provisions". These include allocations of a proportion of shares of privatized companies to employees free of charge or otherwise accompanied by discounts or special sale conditions, as well as allocations of a proportion of such shares to small investors (both being axioms of privatization policy in many countries), employee share ownership plans, management or employee buy-out schemes, schemes of employment protection in privatized companies and privatization-related social support measures. In the countries in transition, mass privatization schemes have been used, involving population-wide distribution of vouchers or certificates free or charge or for a nominal fee which can be used to exchange for the shares of privatized enterprises or for the certificates of investment funds holding such shares. These "social provisions", by giving employees, small investors, managers and the general population a stake in the equity of privatized companies, can help to build up support for the privatization process.

25. The importance attached to social objectives also stems from the realization that social problems arising from privatization can undermine the credibility or success of privatization. In Thailand, for example, where the majority of State employees enjoy better conditions of service than their private sector counterparts, the authorities consider the social aspects of privatization to be the number one problem. In Ghana and many other countries, where there is high unemployment and under-employment, the major concern has been the loss of employment of a large number of workers due to privatization.

26. In Malaysia, the social objective of protecting employment has very much influenced the design and implementation of the privatization programme. The policy decisions taken provide that: no staff of privatized firms may be retrenched within the first five years of privatization, except on disciplinary grounds; staff redundancy, if any, will be resolved through normal attrition, redeployment and expansion of activities; affected personnel, upon privatization, shall be offered a package of employment benefits on no less favourable terms and conditions of service than those enjoyed by them while in Government service; such personnel shall be given the option of joining or not joining the new company; those not wishing to join will be retired and given their rightful retirement benefits immediately; and those wishing to join will be offered two schemes of service, one which replicates the Government scheme of service and the other which is commercially-oriented, under which the employees are entitled, among other things, to purchase the firm's shares and to enjoy such bonuses as the firm's performance may warrant. In addition to offering shares to employees, employee stock ownership programmes and an employee loyalty share scheme may be considered, as in the case of the privatized electricity company. These schemes have been introduced to enhance the employees' sense of loyalty and

commitment to the company. In general, the packages offered by the Government have promoted cooperation from employees and reduced resistance to privatization.

27. Schemes to protect employment in privatized enterprises have also been introduced in other countries. In Pakistan, employment is assured for one year after privatization; employees whose services are terminated after 12 months are entitled to unemployment benefits for two years and may be provided with training and soft loans to facilitate their self employment. In Sri Lanka, employment in privatized companies is protected for two years after privatization. Likewise, schemes for employment protection in the privatized companies of up to two years after privatization have also been developed in certain Eastern and Central European countries. In Poland, social packages, individually tailored to each privatized enterprise, and negotiated with the participation of trade unions, usually contain a period where reductions in the workforce are limited to natural attrition, a requirement for the company to indicate the plan for the workforce after the expiry of this period, assurances on the company's intentions should it go bankrupt after privatization and sometimes arrangements whereby the investor agrees to help finance the reserved share acquisition for the company's employees. The Government stresses long-term thinking in bringing the negotiating parties together.

28. In Germany, a special scheme is being developed for public utilities to be privatized. Under such a scheme, employees of such enterprises would be asked to switch to private contractual arrangements. Those not willing to do so would be taken over by an ad hoc employment company which would maintain the old contractual arrangements and lease the labour to one of the successor companies.

29. In Senegal, there have been regular consultations and information meetings with the entrepreneurs and the labour unions. Legislative and practical measures have been adopted to safeguard employment, one of the important objectives of privatization policy, and the acquired social rights of the workers. Workers individually or collectively have acquired shares or assets of privatized firms. In the choice of buyers, criteria regarding viable business plans, commitment to employment protection or creation have been used in negotiations with potential buyers; other things being equal, preference will be given to buyers who take into account the preoccupations concerning the social aspects.

E. Relationship to other enterprise reforms

30. Earlier, mention has already been made of the use of commercialization and corporatization in preparing PEs for divestiture. This practice is often accompanied by financial restructuring in order to enhance the financial viability and market value of the firm. However, whether for policy or financial reasons, commercialization and corporatization may not lead to divestiture. Some 28 commercialized enterprises in Nigeria, some 37 corporatized enterprises in Finland, and several corporatized enterprises in Pakistan and the Netherlands remain under State ownership. Commercialization has been used as a matter of policy in order to improve the performance of certain PEs which are to remain in the public sector (Nigeria, United Republic

of Tanzania). Corporatization has also taken place in Indonesia, followed, in some cases, by the selling of shares in the capital market. Other enterprise reforms include management privatizations. Thus, 35 of the 37 hotels and several of the firms slated for privatization in Morocco are already operating efficiently under contract to private management, and their divestiture is not expected to result in any significant change other than that of ownership.

31. In Australia, privatization is seen as an adjunct to microeconomic reforms designed to improve the performance of PEs through the adoption of corporate plans, financial performance objectives, a reduction in direct State control and improved quality of information for the assessment of their performance, as well as to strengthen competitive pressure. Another reform in terms of the institution of a performance evaluation system for PEs is also to be found in countries like Indonesia and the Republic of Korea. In these countries, PEs are classified into several categories (three in each case) and the law provides for PEs which should be (partially) regulated by the Government through the performance evaluation system and those which should be regulated by the market. In the Republic of Korea, regulation is left to the market where the State holding in the enterprise is less than 50 per cent. Obviously, such regulation can only take place effectively in a competitive environment. Privatization, by demonopolization, i.e. the breaking up of monopolies into smaller viable units, and by increasing the number of competitive actors, can help to enhance competition between PEs and private enterprises. Such competition, by facilitating performance comparisons, also helps the process of the evaluation of the performance of PEs by improving the availability of information on the performance and efficiency indicators of similar enterprises and related sectors.

32. In the Netherlands, corporatization of PEs, together with the strengthening of competition, may take the form of a public or private limited liability company (for commercial activities) or of a foundation (for non-profit making bodies). Post and telecommunications have been converted into a wholly State-owned holding company, with several subsidiaries, including one for postal services and one for telecommunications. The State plans to reduce gradually its share in the company to a minority holding, with the first sale of its shares in 1994. The new company has the right to raise capital on the private capital market. Courier services and terminal equipment are excluded from its monopoly. Its current monopoly on infrastructure may be restricted by new EC regulations designed to strengthen competition in both postal services and telecommunications. Corporatization of PEs, together with deregulation, has enhanced competition for the State-owned limited liability companies and for private sector companies. Corporatization may be followed by the sale of all or part of its interests (e.g. Postbank). This form of gradual privatization may be chosen on financial and economic grounds if corporatization, together with appropriate reorganizations, may be expected to increase their net worth and thus their market value after a certain period of time prior to sales (e.g. Postbank). This process, by subjecting the agencies to increased risks and responsibilities, as well as the scope for development, has provided a "cultural shock" to get the commercially-oriented organizational changes necessary for increased efficiency off the ground. Private financing of infrastructure (tunnels and bridges) is another form. Contracting out is mainly used for support services and ancillary activities. Commercializations in the field of arts and sports are also on the increase.

33. In France, a number of PEs have transited from the private sector to the public sector and back to the private sector quite successfully. In the passage through the public sector, several PEs have been restructured and placed on a sound footing before being returned to the private sector. When PEs are able to compete with private companies, privatization is the logical consequence of the reform process. Further, management teams, whether of PEs or of private firms, often have the same background or training. The major schools of management have provided managers for both sectors and this element can constitute a favourable factor for privatization.

34. Where the private sector is relatively small and/or inefficient, as in many low-income developing countries, it is often difficult to obtain efficiency gains in PEs prior to sales and the opportunities for their sale are often limited. In such a situation, it is all the more important that the Government take steps to improve their performance by subjecting them to commercial disciplines, whether or not they are to be prepared for divestiture, and to strengthen the private sector by promoting competition and by providing a supportive environment, including its financial, legal and administrative aspects, for entrepreneurial and private sector development. Timing, the sequencing of reforms and the process of sales are crucial in such situations.

35. However, in many such countries, important constraints to parastatal sector reform or privatization remain. In the United Republic of Tanzania, the major constraints to progress at the technical level include: lack of clear guidelines on levels of State ownership; and lack of experience in negotiation, valuation, treatment of debt and handling of laid-off workers. The lack of a clear institutional framework has also been a constraint; partly to overcome this, the negotiation and approval process is being simplified through the establishment of a Parastatal Sector Reform Commission in 1992, vested with negotiation authority, with the support of the sectoral Ministries. The settlement of debts has been a hurdle for several negotiations under way, especially in the case of insolvent firms where the realization of the sales of the assets would not cover the amount of the unserviced debts. To turn them round, it is felt that a supportive environment is necessary, including continued reforms of the tax regimes. Other measures being undertaken include financial sector restructuring, long-term financing and capital market development and legal and regulatory reforms, including revision of the Company Law. However, progress is very slow. Only a small minority of the 300 commercial PEs have been affected; and deals are taking years rather than months to conclude. Likewise, in Niger, the insufficient number of economic operators in the industrial sector and the lack of information and of awareness have impeded progress. The drop in the meagre State resources, due to an unfavourable uranium market, drought and a general downturn in economic activity, has meant that the Government cannot meet the expenses of parastatal sector reform.

II. MACROECONOMIC CONSIDERATIONS

36. Practically all the privatization programmes have formed part of structural reforms or economic liberalization measures undertaken by the countries concerned. They have been aimed at: reducing the dominant role of the State relative to the private sector; modernization of the role and

structures of the State to make it more supportive of the fundamental role of the private sector in national economic development; enhancing competition and efficiency; and internationalization of the national economy. More specifically, the objectives have included: development and strengthening of the financial markets and institutions, including through the privatization of commercial banks and pension funds; exchange rate and trade liberalizations; promoting deregulation, reforming the fiscal system, lifting domestic price controls and eliminating subsidies; attracting foreign investment and promoting exports; as well as turning round PEs and strengthening the private sector. For the countries in transition in Eastern and Central Europe and the former Soviet Union, privatization has formed an integral, if not the dominant part, of a comprehensive restructuring and institutional rebuilding of the economy in order to transform it into a market system.

37. The proper alignment or sequencing of structural reforms and liberalization measures can have an important effect on the privatization process. For example, the decontrol of prices in order to allow them to find their market-clearing level, together with the reduction or removal of subsidies for certain goods or services, may set off inflationary pressures, including through the wage-push phenomenon. Such price instability, together with any tightening of monetary policy in order to fight inflation, may create uncertainties and discourage private investment. Where there is already a shortage of goods, the problem of inflation will be further compounded, particularly if at the same time there is a "monetary overhang" over the economy. In such circumstances, the liberalization of trade and payments risks aggravating the balance of payments situation and exerting heavy pressure on foreign exchange reserves. Such a consequence, together with the continuing need to curb inflation, may make it necessary to maintain high interest rates; and the resulting uncertainties and market pressures will make it difficult to achieve successful privatizations either in terms of sales or of the survival of the privatized enterprises.

38. Thus, for privatization to succeed, it is important that structural reforms and liberalization measures be introduced so that a measure of macroeconomic stability is established early in the privatization process, including in its preparatory phase. High inflation distorts price signals, gives rise to uncertainties, including concerning asset valuations, and creates additional risks for investors. Investors may in fact prefer fixed-return financial instruments like bonds to stocks which may be negatively influenced in the future by monetary and fiscal measures to curb inflation. High interest rates resulting from a tightening of monetary policy may lead to a recession, rendering it difficult for the economy to absorb retrenched workers. Such a situation is hardly conducive to the creation of a climate of confidence for private investment and of optimum conditions for the sale of public enterprises. In the post-privatization phase, if inflationary pressures, high interest rates and tight monetary policy persist, privatized firms may face difficulties in raising the necessary capital. The development of SMEs may also be thwarted, thus blocking other possibilities for job creation. If, as indicated earlier, internal imbalances are compounded by external imbalances, import liberalization cannot be undertaken without imposing additional strains on foreign exchange availability; and continued import restrictions may mean depriving the market of the necessary dose of competition and privatized enterprises of their essential inputs or of inputs

at international prices. Privatized firms may thus find themselves unable to compete internationally on equal grounds. Foreign investors may also stay away because of inflationary pressures and their effects on growth and because of import restrictions due to balance of payments difficulties. For example, in the Russian Federation, the programme of large-scale privatization was preceded in 1991-1992 by price and other liberalization measures. Recently, the pace of privatization has slowed down due partly to the political situation but also to the continuing economic difficulties. This last factor, together with inadequacies in infrastructure and in the regulatory and legal framework, has had a dampening effect on foreign investment which has not come up to expectations. Further, continuing high inflation, coupled with a steep devaluation of the rouble and a growing popular mistrust of the privatization programmes, has jeopardized the objective of allowing the general population to share the national wealth through mass privatization.

39. The problems which high inflation or hyperinflation create for the privatization process are also illustrated by the case of Bulgaria. There, privatization is being planned in an unfavourable macroeconomic environment, with steep inflation (80 per cent in 1992), high interest rate (47 per cent in January 1993) and high unemployment (in agriculture, trade and construction). The effect of high inflation on asset values will be to render the distinction quite meaningless between branch privatizations by economic ministries (up to 10 million leva in value) and State privatizations by the Privatization Agency (over 10 million leva). It risks transferring many of the 289 units in the former category to the latter category, where 94 enterprises are listed for 1992/1993, and thus creating a considerable additional burden for the Privatization Agency. The steep inflation also calls for revisions of asset valuations, thus adding to the preparatory expenses. Further, high interest rates have a negative effect on the debts of public enterprises and will restrict the use of bank credit for privatization transactions. At the same time, since privatization has to be undertaken under political pressure, quick results are expected and are needed for the credibility of the process. In this and some other countries facing a similar situation, the choice is often between the bad and the worse.

40. In a number of other countries, however, privatization has taken place in a favourable macroeconomic environment. Portugal, for example, in implementing its privatization programme, has benefitted from its accession to the EC in 1986, together with the associated structural reforms and increased investment, including EC structural funds and increased flows of foreign direct investment.

41. An important factor in the success of a major privatization programme is its relation to the Government budget, particularly its short-term impact on public finance. In some countries, the Government often faces a difficult choice regarding the use of privatization proceeds: either to retire long-term debt and reduce budgetary deficits or to use them largely to finance socially-related support measures in order to minimize social difficulties. The use of transitional measures in order to organize an orderly transfer of PEs to the private sector can also have a significant budgetary cost (as in the United Republic of Tanzania). However, increases in budgetary revenue from the privatized firms may take a longer time to realize and may also depend on tax reforms, particularly of the tax base.

42. For privatization to achieve allocative efficiency, it is essential that privatized firms assume fully their commercial and investment risks, including the risk of bankruptcy. This presupposes that an appropriate regulatory and legal framework is in place and that the laws are enforceable. However, it also raises the issue of possible massive retrenchment of workers arising from the bankruptcies of such enterprises. The Government can step in by assuming the large debts involved, but at some budgetary costs. Such a situation is fairly frequent in Eastern and Central European countries where many trade-oriented firms have been weakened by the collapse of CMEA trade and for which the straight application of financial and commercial rules would probably entail bankruptcy in the current situation. In these and other similar situations in developing countries, there is a need for facilitating the access of the countries and enterprises concerned not only to financial resources but also to markets in other countries.

III. THE ROLE OF THE STATE

A. Changing roles of the public and private sectors

43. The rebalancing of the public and private sectors implied by privatization means disengaging the State from those activities which are best done by the private sector so that the State can concentrate its energy and resources on its "core" functions and act where the market fails. Those functions which the Government is particularly well placed to do are: to promote competition and allocative efficiency through trade and competition policies and appropriate regulatory instruments; to provide a supportive and enabling environment for private sector development, technological innovation, structural change and productivity growth by means of appropriate macroeconomic, technological, industrial, human resources development and other policies, including policies to attract foreign investment for enterprise, industrial and infrastructure development; to protect the environment and to safeguard national security; and to provide vital economic and social services, as well as social security and poverty alleviation measures. The Government also has to compensate for market deficiencies, i.e. where investment is needed but lacking because it is too big or unprofitable for the private sector, for example investment in infrastructure or in certain research and development activities.

44. In the countries members of the European Community, a variety of EC regulations, including in the area of competition policy, are increasingly influencing the redefinition of the Government's role by putting an end to the protection of public enterprises and by strengthening competition and market disciplines in the public sector. Some of these countries, which are still lagging behind, are thus reducing the role of the Government and strengthening competition in order to facilitate the adaptation of their economies to the EC regulations, as well as to prepare themselves for the establishment of the Economic and Monetary Union towards the end of the decade.

45. Although the strengthening of the private sector, coupled with a redefinition or scaling down of the public sector, is no longer disputed, there are still differences among countries, concerning the nature of the strategic or vital services that the State should continue to provide. In fact, the definition of "strategic" sectors can become a moving political

target, with those opposed to the privatization of a particular enterprise sometimes succeeding in having it classified as "strategic". In order to avoid such a situation, it is important that the extent of privatization be defined early in the process as part of the privatization strategy. Further, if the objective is to promote competition between PEs and their foreign competitors and therefore to allow for their privatization in the future for this purpose, it is important not to define "strategic" sectors too broadly.

46. In many countries, there are certain activities, notably the provision of public utilities like electricity, communications and water supply, for which the reasons for State involvement in the first place, including the scale and costs of the investments or the economies of scale and scope involved, are still valid. However, as will be seen later, while the State may have to continue to undertake such activities, there is scope for competition, as well as for (increased) private sector involvement. In fact, because of budgetary constraints, the latter may be necessary for the expansion or modernization of such activities.

47. There may also be difficulties for the State to disengage itself from its larger economic activities very quickly because of the shortage of private capital or of management and entrepreneurial skills. There may also be political constraints to the disengagement of the State in various activities. In such circumstances, for rebalancing to be achieved, the State may need to scale down its support to public enterprises or impose more stringent conditions for such support, pursue policies to improve their performance by subjecting them to competition, as well as to encourage the growth of the private sector, including through joint ventures. Similar policies have been pursued in various countries (as in China).

48. The variations in practice may be illustrated by the examples of various public utilities like telecommunications, electricity and railways. As stated earlier, such public utilities remain classified in many, particularly low-income, countries as strategic industries and are therefore not privatizable. In any case, without adequate legislation and regulatory capacity, which is often the case in many of these countries, it is questionable whether they should be privatized since doing so would simply mean transferring economic rents to the private sector. However, a number of countries have restructured and privatized them, as well as opened up competitive sectors in these industries to competition. Thus, Argentina, Malaysia, the Republic of Korea and Venezuela, among others, have privatized their telecommunications industries. In the United States of America, the industry is privately-owned. In some cases, privatization extends to the promotion of competition in basic services, as well as in other sectors (Japan, New Zealand, the United Kingdom). In Colombia, the basic telecommunications services are contracted out to a private company. By contrast, in Jordan, the telecommunications company providing basic services is to be commercialized, with other services to be contracted out to private sector operators. In the electricity industry, electricity generation is open to competition in various countries (Portugal, the Netherlands, New Zealand, Sri Lanka, United Kingdom and the United States). In Côte d'Ivoire, electricity operations are leased out to a private operator. In the railways industry, while the networks are managed by the State in Colombia, the railway services are contracted out to a private operator. In Japan, as part of a privatization exercise, combined with the

promotion of competition, the national railway company has been restructured into six regional companies and freight operations have been transferred to an independent national company with access to the same railway networks. Canada has licensed a private operator to compete with the State-owned railways company. In the United States, CONRAIL, the rail freight service, has been privatized.

49. Likewise, there are variations in practice concerning the provision of public services like solid waste collection and disposal, mass transit operations, urban renewal and road maintenance. While many countries consider these activities to fall within the public sector, some other countries like Colombia, the Netherlands, the United Kingdom and the United States contract out various of these activities to the private sector. Similarly, some countries like Indonesia, Malaysia, the Netherlands, Thailand and the United States encourage, with the help of operating concessions granted to private sector partners, the private development and operation of certain infrastructural facilities like toll roads and bridges.

50. In New Zealand, the application of private sector operating principles, though not profit objectives, has been extended to social services delivery agencies, notably hospitals and to a limited extent schools. To the extent practicable, elements of the same approach have also been applied to "core" (non-trading) entities. Thus they work to specified objectives, pay a charge on their assets and have considerable flexibility in choosing the most cost-effective inputs, including personnel. Their chief executives have an "arm's length" relationship with their Ministers in matters of administration. Gradually, some agency activities are becoming contestable. An example is the calling of tenders for the operation of two new prisons, previously the exclusive preserve of the Justice Department.

51. In the United States of America, where the economy is predominantly private, the privatization experience has emphasized the private provision of public services and facilities rather than the sale of PEs. Contracting out of public services is the most widespread form of privatization. These arrangements have covered solid waste collection and disposal, prison construction and management, mass transit operations and health care. The move towards private development of infrastructure has been driven by Government fiscal pressures, together with an almost 50 per cent decline in the share of GNP devoted to public works spending, a similar percentage decline in the Federal share of the nation's total spending on transportation infrastructure and taxpayers' preference for direct user charges over tax or fuel tax increases. Many infrastructure facilities can generate enough revenues from user fees and neighbouring commercial development to attract private financing. Those commonly targeted include toll roads and bridges, airports, high-speed inter-city rail systems and water treatment facilities. However, Government guarantees are sometimes needed in order to attract private financing.

B. Institutional changes

52. The privatization process, together with other structural reforms, has entailed institutional changes in terms of reshaping or modernizing the structures of Government, the creation of new institutions for privatization,

regulation and other functions and, in the case of the countries in transition, the creation of the basic structures of a market economy.

53. In Germany, the transformation of a command economy in the eastern part into a market economy has another dimension than privatization as an effort to reduce the role of the State in certain areas of a mixed economy. The process has had to tackle the problem of mass privatization and of converting a whole command economy into competitive private enterprise structures within a minimum period of time. The steps taken have involved: the creation of a monetary and economic union by extending the market economy rules of the former Federal Republic to the former German Democratic Republic (GDR); the conversion of the once-dominant 330 conglomerates into over 8,000 limited liability or joint stock companies by a single legal act; the establishment of a parastatal privatization authority (Treuhandanstalt) as the legal owner of almost all of the ex-GDR PEs; the further splitting of the 8,000 enterprises into some 13,000 firms in order to facilitate privatization and to foster competitiveness; and the establishment of close cooperation between the Treuhandanstalt and the Cartel Office in order to foster competition and to prevent abuse of market power. The result of this process has been an extremely rapid structural change.

54. In Colombia, emphasis has been placed on a redefinition of the role of the State and of the professional associations inside the productive sectors, as well as of the relationships of the latter with the State and the society in general, so as to rationalize their roles and promote effective concertation among all the parties concerned. This has involved the creation of various consultative mechanisms for Government-private sector policy dialogue, including an Industrial Council, a Standards and Quality Council and a National Council for Technological and Industrial Development (for centralizing the financing and promotion of national technology). Further, the Ministry of Economic Development, its Office of the Superintendent of Industry and Trade and its Office of the Superintendent of Companies have been restructured and their roles redefined, with the aim of achieving deregulation, removing obstacles to foreign trade and internal controls on firms, industries and markets, as well as strengthening private initiative, entrepreneurship, administrative efficiency, technological development and competition. The statutory function of the Institute for the Promotion of Industry is first to promote and finance investment projects and then to dispose of them; it has made an important contribution to the development and strengthening of private industry. In the area of technological development and quality standards, efforts are aimed at providing support to the acquisition and adaptation of technology, the promotion of quality, the reinforcement of technical training and of environmental protection. A Fund for Industrial Modernization and Technological Development (FOMITEC), with its own legal personality, has been created, to be financed by both public and private funds.

C. Competition and regulation

55. Privatization raises the issues of competition and of regulation. Without a competitive environment, privatization cannot achieve the efficiency gains it is meant to achieve. In fact, a major lesson drawn from privatization experiences suggests that, while ownership often matters, competition matters

even more. The issue of competition is thus central to the process of privatization.

56. Where the market is competitive, i.e. where there are no barriers to entry, competition may be encouraged or strengthened through appropriate trade and competition policies and by providing a supportive environment, including its macroeconomic aspects, for the development of entrepreneurship and of enterprises, including SMEs.

57. Where a market is non-competitive or monopolistic, i.e. where a single firm can produce total industry outputs more efficiently than two or more firms, the issue is much more complex. Such a situation may arise because demand and cost/technological conditions or the small size of the market serve as effective barriers to entry. In this kind of "natural monopoly" situation, there is a potential conflict between cost efficiency and competition; while price competition might be enhanced by the presence of more firms in the market, more firms might lead to higher unit costs and thus to reduced cost efficiency. Thus, in privatizing a "natural monopoly", this competition/cost efficiency trade-off needs to be borne in mind. However, competition may be introduced by the liberalization of entry, including the removal of any statutory restrictions, and the opening up of the market to foreign competition. Sometimes threats of entry may be sufficient as a form of competitive pressure. However, depending on the nature of the market or of the enterprise, a period of adjustment may be needed, during which the enterprise may be corporatized and placed on a sound financial footing, before it is subjected to the full force of competition.

58. The issue of regulation applies particularly to public utilities, which, as indicated earlier, may include both "natural monopolies" and competitive sectors. The "transportation networks" of public utilities, e.g. electricity transmission lines, gas and water pipes, telecommunications or railway networks, are "natural monopolies" in the sense that their extensive investment or "sunk" costs or economies of scale act as effective barriers to entry. However, other sectors of public utilities may be open to competition through interconnection to the networks. Thus, in electricity, generation and retail supply are contestable. In telecommunications, competition may extend beyond interconnection to the establishment of new networks, the supply of user equipment, value added services such as data transmission, etc. In railways, competition may be introduced, as in Canada, by the licensing of access to the railway network to a private sector operator to compete with the State-owned company.

59. In circumstances where contestability does not lead to reduced cost efficiency, competition in public utilities may be promoted by regulating the conditions of entry, including the terms of interconnection to the networks. Where a particular sector of a public utility is fully contestable, for example, the provision of value-added services or of user equipment in telecommunications, competition is the best regulator; however, appropriate competition policy may be needed in order to safeguard competition. Competition policy may also be needed in order to supplement the work of regulatory bodies for public utilities and to deal with any regulatory failures on their part. Thus, depending on the situation and on the particular sectors of a public utility, competition, competition policy and

economic regulation can all play a role in regulating the industry for efficiency.

60. The regulation of public utilities may include a number of objectives -- economic, technical, environmental and other aspects of public policy. Economic regulation is designed to protect consumer welfare and to promote efficiency by fostering competition and by providing incentives for innovation and productivity growth. Technical regulation is concerned with the observance of technical, health and sanitary standards, including, for example, health standards in drinking water. Such technical regulation may be part of quality regulation. In the cases of electricity and water, economic regulation is closely linked to environmental regulation including pollution control relating, for example, to power generation or to sewerage treatment and disposal. However, technical and environmental regulations are not confined only to public utilities. Regulation of public utilities may also include other aspects of public policy, including social or distributional objectives such as the subsidization (either through direct subsidies or otherwise) of essential services for certain social groups.

61. Economic regulation can take the form of price regulation, rate of return regulation or a negotiated contractual concession. Price regulation is being used much more than rate of return regulation. Price regulation is less costly and less time-consuming, and provides a stronger incentive to efficiency, than rate of return regulation. However, it may be difficult to determine the adjustment for productivity gains in the price regulation formula over a five-year period (the normal period used) in unstable macroeconomic conditions. In the case of contractual concessions, monitoring may be needed, for example to monitor security and quality of service. Quality and output standards may be built into a contractual agreement, with penalty clauses for shortfalls, as well as specifications that consumers will pay only for the services rendered. Stability in the terms of a contractual concession is important for the market value of the enterprise concerned.

62. The lessons learned from the regulation of public utilities point to the need for: (a) establishment of a clear regulatory framework for each public utility with well-defined rules of the game for all the parties concerned (the State, the service providers and consumers); (b) establishment of the regulatory framework and the regulatory authority before privatizing the public utility; (c) creation of market structures to allow for maximum competition; (d) creation of competent regulatory authorities and ensuring their independence from political interference; (e) ensuring that the procedures used by the regulatory authorities are transparent and that their decisions are made public; and (f) rationalization of the structures for related industries, e.g. those belonging to a particular sector such as energy, in order to keep the number of regulatory bodies to a minimum.

63. Where the regulatory capacity is not adequate or is subject to political interference, a negotiated contractual concession may be used, which may be more attractive for the private sector investor-operator than price or rate of return regulation.

64. In Australia, the recent restructuring of its telecommunications sector involved at once promoting competition and ensuring regulation in a "natural

monopoly" industry. Three PEs were involved: Telecom, which operated the domestic telecommunications network; Overseas Telecommunications Corporation (OTC), which ran the international network; and Aussat, which supplied the domestic and international satellite services. Telecom also had responsibility for all regulatory functions. After having announced a series of reforms to promote competition in the industry, including the merger of Telecom and OTC into the Australian and Overseas Telecommunications Corporation (AOTC), the Government sold Aussat to a private company, Optus, and allowed it to compete with AOTC by establishing a second network. While AOTC still has monopoly power in some of its services, and the competition between it and Optus is still at the stage of duopoly, full competition is to be phased in by 1997. At the same time, Telecom's regulatory functions were transferred to an independent regulatory body, Austel, which has the power to protect competitors from anti-competitive behaviour and consumers from abuse of monopoly power, as well as to enforce technical regulation and to promote efficiency within the industry. Thus, the situation where the owner/operator was also the regulator, a situation which can be inimical to fair competition, has been ended.

65. In the United Kingdom, the Government has established a system of independent regulation for the privatized utilities. For each of the sectors concerned, there is an independent regulatory body endowed with a wide range of powers and duties to promote the interests of consumers. Each of the privatized utilities has a price formula which in most cases limits annual price increases to no more, usually less, than the rate of inflation. In addition to efficiency gains in terms of lower prices, there are non-price benefits for consumers, including their entitlement to compensation if the utilities fail to meet any of the required standards. The Government has opted for price rather than rate-of-return regulation in order to provide a greater incentive to the companies to improve efficiency.

66. In Malaysia, new regulatory bodies to protect consumer welfare in terms of price, quality and availability of services have been established for telecommunications, the postal service, gas, electricity and railways. The existing bodies continue to undertake regulatory functions for ports and highways, while the State continues to be responsible for water supply. A regulatory body for airports is being planned. The role of the regulatory bodies is to ensure a proper balance between the objectives of protecting consumer welfare and of promoting a healthy development of the industries. In the medium term, the regulatory bodies will be merged to cover three areas: telecommunications, transport and utilities. The question of creating a single authority is under consideration. In Colombia, a Telecommunications Regulatory Commission has been established, responsible for promoting and regulating competition, the protection of consumer welfare, the granting of licences for the provision of basic services and for proposing the corresponding rates, fees or tariffs to be paid by the concessionaire. A regulatory body for ports has also been established to grant concessions, normally for a period of 20 years, to privately-owned regional port companies for the operation of port services, to promote competition and to determine a tariff-setting formula consistent with the achievement of internationally-competitive port services and the encouragement of new productive investment.

IV. TECHNICAL, LEGAL, FINANCIAL AND OTHER ASPECTS

A. Legal issues

67. A host of legal issues have to be addressed and the necessary laws enacted in connection with the privatization process. These concern, inter alia, the enabling legal framework, including the machinery, for privatization, the preparation and methods of privatization (e.g. the legal status of PEs, the Government employees concerned, their pension funds, procedure and conditions of privatization, selling or transfer techniques, the applicable laws, etc.), competition and regulation policies and structures and privatization-related social support measures. Where necessary, laws may also have to be enacted concerning the financial markets and institutions, foreign direct investment, joint ventures, property and contract rights, company laws, bankruptcy laws and legal enforcement procedures. These laws are part of the essential requirements for the development and growth of the private sector. Many of these issues require complex legal instruments which take time to draft and to enact, and the whole process can be time consuming. It can be further aggravated by a complex procedure and machinery for privatization. The land ownership issue is important since, without the land title to serve as a collateral for bank loans, the viability of a privatized company may be seriously jeopardized.

68. In Turkey, it was found that the complex nature of legal instruments and the plurality of decision-making bodies had made the process time-consuming. For this reason, the Public Participation Administration has proposed (i) combining all laws into one law; (ii) streamlining the decision-making structure by appointing the Public Participation High Council as the sole decision-making body. The Public Participation Administration has also proposed the creation of an Unemployment Insurance Fund (with 15 per cent of privatization proceeds), a Debt Liquidation Fund (with 15 per cent of privatization proceeds) to write off partially or wholly the outstanding debts of certain firms to be privatized; and regulations concerning Government employees (transfer to other Government bodies, where possible, or to the private sector, etc.) or concerning the transfer of land ownership rights to the firm after it has been evaluated by the Treasury, thereby increasing the value of the assets of the firm.

69. In Portugal, each privatization involves a number of steps, including specific legislative acts. A two-phase privatization being very frequent, a period of up to 18 months may be required to implement it. In Ghana, the title to land, which was not always transferred to the public enterprises, has become an important legal issue. Delays have occurred due to delays in the transfer of title to land and to the need to convert PEs into limited liability companies. Other legal disputes have also affected the pace of privatization.

70. In Lithuania, more than 200 Government decrees and by-laws regulating the privatization process have been adopted. In Australia, Acts of Parliament have been passed to provide the necessary legislative and administrative and regulatory framework for resolving the legal issues prior to privatization. Consequently, the Government has experienced minimal legal problems during the implementation and follow-up of privatizations. In Pakistan, laws have been

amended to facilitate privatization. Further, the process of privatization has been given legal protection against future reversal under the Protection of Economic Reforms Ordinance, 1991.

71. There are a number of areas where exchanges of experiences and of legal texts may prove useful, for example, the enabling legal framework for privatization; simplification or consolidation of laws governing various aspects of the privatization process; laws pertaining to the regulation of privatized monopolies, the establishment of regulatory authorities and experiences in this area; and legal texts and experiences relating to employee share ownership plans, management buy-outs, management buy-ins, etc. An indication of the priorities of the Ad Hoc Working Group will also help the secretariat in compiling a bibliography of the relevant national legal instruments used, as requested by the Ad Hoc Working Group.

B. Criteria for selection of enterprises for privatization

72. Various criteria are used for the selection of enterprises for privatization. In Morocco, for example, PEs are selected according to whether they are profitable or potentially profitable; they have a significant public participation; they are already subject to competition, particularly applicable to industrial and commercial firms; they have a major economic role without having an important public service role; they have no major overstaffing problems; they have a regionally diversified base; and they have a legal corporate form. In Turkey, PEs are selected on account of their reduced economic role (small size and market share) in their particular sectors and of the marketability of the State shares. In Portugal, priority has been given to banks and insurance companies because of their decisive importance and because of the existence of the necessary supervisory and regulatory instruments, including EC directives. In Pakistan, priority has been given to banks and industrial PEs. In Ghana, the programme began with small or loss-making PEs. Some such enterprises had been restructured or leased before they were sold. In Egypt, PEs to be selected, particularly in the first few years, will be those which would minimize economic disruption, i.e. profitable and viable PEs operating in competitive markets without the need for restructuring and without any significant overstaffing. In Greece, the selection of PEs for sale is governed by the objective to reduce Government losses by the sale of debt-burdened, over-staffed and loss-making SMEs or to increase Government revenue by the sale of profit-making PEs.

73. In Senegal, certain strategic PEs which contribute to the achievement of important socio-economic objectives are not privatizable. Among the non-strategic firms, those which have no economic or financial potential will be liquidated, while those which are profitable or potentially profitable will be transferred to the private sector. In the Republic of Korea, privatization is to be excluded where the public interest is more important than efficiency; the capital investment involved is exorbitant or prohibitive for the private sector; and where there is no prospect of profitability and thus no demand for the company's share capital. In Bulgaria, the criteria for the selection of small firms for auction include: interest of potential investors; degree of readiness of the firms (legal status, documents, etc.); the social situation, both in the firms and in the region; and environmental questions.

C. Methods and sequencing of privatization: sale and transfer techniques

74. The forms of privatization described in the country presentations range from management privatization through commercialization and corporatization to capital privatization. Commercialization and corporatization have been applied generally to medium or LSEs. PEs may be commercialized (Nigeria, United Republic of Tanzania) or corporatized (Finland) without leading to divestiture. Some corporatized PEs have the right to raise capital on the private capital market (Finland, the Netherlands) Further, some PEs are able to involve the private sector in the increased capitalization of their enterprises (Senegal, Tunisia) or to acquire shares of private companies (Morocco), giving rise to some form of "rolling privatization". Capital privatization may also be preceded by management privatization, generally in the case of SMEs (Ghana, Morocco and Senegal). However, management privatization may be used as an end in itself (Côte d'Ivoire, Ghana, Niger, Senegal, Sri Lanka, Togo). It is an important tool for the contracting out, sometimes combined with the private development, of public utilities (Argentina, Colombia, Côte d'Ivoire, Malaysia, Thailand, the United States). In general, the technique chosen depends on the enterprise needs in terms of new capital, management know-how, technology, market contacts and incentives of ownership, including good corporate governance.

1. Privatization of capital

75. A number of technical problems need to be addressed and resolved in connection with a sale. These include, among the most important ones: the valuation of assets (and auditing as well sometimes); the method and terms of sale, including pricing and ownership-sharing formulae; and enterprise restructuring, including financial rehabilitation, particularly the treatment of debts, prior to sales.

76. A common method used for valuation is to calculate the net present value of future cash flows discounted by the cost of capital (as in Sri Lanka, Turkey). However, other methods are used, including using the net asset value and the operating cash flow, together with an assessment of the market situation (Finland); as well as the asset value, the profits earned, the stock market share value, the existence of subsidiaries and future prospects (France, Morocco). Forecasts of earnings are based on projections submitted by potential investors (Ghana). In the case of public utilities, the valuation includes three basic elements: the expected price, the scale of future investment and the tariffs that can be applied (Argentina). The book value may also be used; however, it has the disadvantage that it does not always represent the true value, for example, in terms of future income streams.

77. Market valuation is difficult to achieve in those developing countries or countries in transition where capital markets are weak or absent. In such situations, the bidding procedure provides a useful instrument for giving market forces a say in the valuation of assets to be sold. Bidding, generally applied to SMEs, has the added benefit of providing transparency. However, where the enterprise is large or complex, valuation cannot be avoided. Even so, bidding may be used for certain parts of the enterprise to be sold; this can help to identify where the viable assets are located. Valuation is

essential where there is only one prospective buyer. An effective organization of different types of auctions and tenders is necessary in order to prevent corruption in the privatization process.

78. There is a range of options open to Governments wanting to dispose of their enterprises or parts thereof. These include: public or closed auctions, usually for small firms; direct negotiated sales to general investors, with or without prior competitive bidding; private placement with "strategic" investors (i.e. investors operating in the same industry or joint venture partners) with or without competitive bidding; public share offer, full or partial; sale to management teams or employees; sale to investment funds; and liquidation followed by the sale of assets. A sale option may also be combined with a contracting out arrangement; agreement on such an option at the beginning of the contract can give an incentive to the contractor to improve the efficiency of the enterprise.

79. With a number of exceptions, mass privatization has been used in the countries in transition in Eastern and Central Europe and in the former Soviet Union. It involves population-wide distribution vouchers or certificates free of charge or for a nominal fee. Such vouchers can be exchanged for the (majority) shares of PEs included in the mass privatization programme. Various methods have been used or are envisaged to allow voucher holders to convert their vouchers into company shares, including directly through auctions (Russian Federation) or computerized bidding (Czech Republic and Slovakia) or indirectly through the purchase of certificates issued by investment funds acting as holding or management companies for the privatized enterprises (Czech Republic, Poland, Romania, Slovakia). These funds normally hold a majority of the shares, with the State keeping a minority holding and a certain proportion allocated to employees. In some cases, in addition to vouchers, a cash quota is required for the purchase of privatized assets (Lithuania).

80. Some particular techniques are also used. In Malaysia, for example, the private sector may initiate privatizations of projects that are unique by submitting proposals. Such proposals are considered on a "first-come, first-served" basis in order to encourage innovation and entrepreneurship. If a proposal meets the guidelines regarding privatizability and uniqueness (i.e. it provides an unique, cost-effective solution to an economic problem, it brings with it certain patent rights or particular know-how, or an additional asset, to make privatization viable), a letter of exclusivity is given to the private sector party to conduct a feasibility study and to submit a complete proposal to the Economic Planning Unit in the Prime Minister's Department. Should the proposal, after evaluation, be found to be acceptable, negotiation will follow and an award will be made when agreement is reached. In Argentina, in order to resolve as many issues as possible in the bidding documents, bidders are required to provide a signed copy of the contract together with the bid. Further, the bid is reduced to one figure -- the highest price or the lowest tariff or subsidy. Bidding based on the lowest subsidy is used, for example, for railways where subsidies are granted, particularly for suburban railways, to be used for investments.

81. In Hungary, the State Property Agency has developed a model for self-privatization. Certain enterprises (with a staff of fewer than 300 and a

turnover and gross property value of less than 300 million forints) can initiate privatization themselves provided that they employ one of the independent consulting and property evaluating companies selected by the Agency and do not violate legal regulations. However, the Agency, as the holder of the ownership rights of the State, needs to give its permission before an actual transaction can take place.

82. While the public offering of shares is commonly used, particularly for large enterprises (where the size of the sale justifies the additional cost involved and where transparency is a particularly important consideration), there are important variations in practice. One concerns the fixing of the share price, which can range from a fixed price offer to a tender offer to a combination of a price and a tender offer (as in the United Kingdom, which pioneered an international global tender and domestic pricing arrangement for the sale of shares of British Telecommunications). Another concerns the targeted buyers, involving a variety of incentive schemes for small investors (different versions of bonus share schemes for long-term retention of shares by small portfolios, as in France and the United Kingdom) and for employees (ranging from limited allocations of free shares, as in Slovenia, Sri Lanka, Tunisia, and the United Kingdom to a fixed percentage, usually 10 per cent, of shares for employees, as in Brazil, France and Venezuela). There are also differences in approach in terms of small buyers, institutional and "core" investors. In the United Kingdom, in the case of some offerings, the "claw back" method allows the number of shares allocated to small investors, if they subscribe in very large numbers, to be increased at the expense of institutions. In France, subscriptions of small investors receive priority treatment and free shares are granted for shares held for more than eighteen months after full payment for them has been made. However, in some other countries like Sri Lanka, the allocation to small investors is invariably a fixed percentage of the public offering. As regards "core" investors, the practice in France is to sell blocks of shares, representing 20-30 per cent of the total, to several "core" institutional investors, selected on the basis of open public tenders. However, in Sri Lanka, where such operations are smaller, the majority holding is sold to a "core" corporate investor. In fact, the authorities in Sri Lanka seem to have settled on a fixed 60:30:10 formula for the public share offering of their PEs, i.e. 60 per cent to be transferred to a corporate investor through competitive bidding (the latter being an axiom of the country's privatization policy), 30 per cent to small investors and 10 per cent free to employees.

83. Broadly speaking, there are three forms of restructuring of a PE: organizational, sometimes involving the splitting up of the enterprise into smaller units and often associated with corporatization and some labour shedding in the process in order to enhance its net worth or sales value before divestiture; financial, involving the treatment of the debts of the enterprise in order to provide a "sweetener" or to ensure the success of its sale: and operational, involving new investment in order to upgrade the enterprise's physical capacity or its technology. Organizational restructuring with corporatization has helped to increase the net value of the PEs concerned (as in France, the Netherlands and New Zealand); however, it is not clear what the cost of such restructuring has been. As indicated below, financial restructuring may be needed because of heavy debts before sales can be contemplated. Where the debt liabilities are large, the State may have no

choice but to absorb them or a major part thereof in order to safeguard the healthy development of the banking system. However, operational restructuring should be avoided; if it is needed but can be avoided before divestiture, it would be better to allow the buyer to do it. The simple reason is that the Government cannot "second guess" what the potential investor would do, and may therefore make the wrong kinds of decisions leading to costly losses. In New Zealand, for example, after NZ$2.3 billion had been spent restructuring a steel company, it was subsequently sold for NZ$ 300 million.

84. In practice, important debts of PEs have led to financial rehabilitation prior to sales. In Bulgaria, where the PEs are heavily indebted, it has been decided to convert part of Government credits into public debt. The State Fund for Reconstruction and Development provides funds for the consolidation and technological innovation of some PEs prior to privatization. In Argentina, PEs have been rationalized or restructured prior to privatization through the cancellation, consolidation or refinancing of their debts; in some cases, the State has assumed some of the debts in order to facilitate sales. In Tunisia, the case-by-case treatment of debts by the Fund for the Restructuring of Public Enterprises has helped to reduce the impact of the debt, for example, on banks and small suppliers In Portugal, financial rehabilitation for some banks has been undertaken, including the injection of new capital, in order, inter alia, to create the necessary reserves for "credit risks" and to provide adequate financing of the pension fund. In Germany, the Treuhandanstalt in principle takes over all old debts of PEs, as well as 90 per cent of past environmental burdens. Preference is normally given to selling the viable assets of a PE and writing off its debt than to transferring the debt and the assets for a lower or even negative price.

2. Privatization of management

85. The privatization of the management of a PE through the granting of a management contract, a lease or an operating concession to a private sector business operator can be used as an end in itself or as a preparatory step to divestiture. The granting of operating concessions can also be used, together with build-operate-transfer schemes, to raise private financing for the development of infrastructure and thereby to reduce the financial burden on the State as well. This kind of arrangement, combining both capital and management privatizations, is a useful option when the State is faced with budgetary constraints for the development or modernization of infrastructure.

86. Management contracts are used in various sectors, including hotels (as in Niger and Togo), agro-industries (Cameroon, Côte d'Ivoire, Senegal) and manufacturing and mining (Ghana). They are also used for plantations in Sri Lanka, where contracts are awarded to private sector operators through competitive bidding and where strict performance criteria are applied in order to avoid asset stripping or short-term profit maximization at the expense of long-term development. In China, where management contracts are used widely and subject to competitive bidding, potential managers are required to submit a business plan, together with their bid for a management contract, with the business plan playing an important role in the awarding of the contract.

87. Leasing is often used where it is difficult to attract large amounts of capital for the rehabilitation or sale of PEs. It is used in various sectors,

including electricity and water supply (Côte d'Ivoire), steel mill and refineries (Togo), manufacturing (Ghana) and hotels (Côte d'Ivoire, Niger). A particular form of leasing is the transfer of the leasehold of State-owned property, including hotels and farm holdings (Jamaica), which gives entrepreneurs with limited capital access to productive assets. In Jamaica, it has engendered many new entrepreneurs who have turned hotels round, upgraded their facilities and services and transformed idle land into productive agricultural areas, including for export crops.

88. In a number of countries in transition, the State is using investment funds as holding companies to provide management expertize and effective corporate governance for their PEs. In the eastern part of Germany, the Treuhandanstalt has also developed solutions involving transfer of management. The model for medium-sized firms is to establish a management company as the owner of the firms with the task of managing 5 to 15 firms. The Treuhandanstalt holds 99 per cent of the capital of the management company, its management organ holds the remaining 1 per cent. The latter is a limited liability company owned by the private managers. Another method is to transfer firms to venture capital corporations, either refinanced by the State and/or by private finance companies such as banks or insurance companies. So far, two State-financed venture capital corporations have been formed, and more are expected to follow.

3. Privatization of infrastructure

89. The privatization of infrastructure or public utilities raises some important issues of its own because of the particular characteristics of infrastructure companies. Such companies are often considered to be of a "strategic" nature. In some countries, the privatization of certain such companies like telecommunications would require a change in the national constitution (as in Brazil and Germany). They enjoy monopoly or dominant market power and need to be regulated. They provide services which generally cannot be exported; thus, their prices are internally determined and they do not earn foreign exchange. Their services are traditionally provided by the State and affect large segments of the population, which means they have high visibility. They require substantial up-front investments with small initial revenue streams and long payback periods; because of the high risks associated with many projects, future returns are heavily discounted. These characteristics create a unique set of incentives and risks for the promoter of infrastructure privatization. Such risks may include inter alia business risks such as deficient demand for the services, financial risks such as exchange rate fluctuations, political risks such as expropriation of the enterprise or environmental risks.

90. The privatization of infrastructure may involve the sale of the infrastructure or sale of the infrastructure company through public offering of shares or to a private investor. Such sales involve far more complex and costly operations than that of privatizing a trading company, for example. Questions such as valuation, enterprise restructuring and industrial segmentation in order to enhance competition, method, sequencing, timing and transparency of sale, underwriting, participation of foreign and "strategic" investors, safeguards (through, for example, the use of "golden shares") against undesirable corporate activity such as hostile takeovers and the

concerns and interests of particular social groups (for example, rural populations) assume great importance and call for particular attention. The treatment of large accumulated debts of infrastructure companies, for example, those of railways in Germany and Japan, also raises particular problems. In Japan, in addition to the restructuring of the national railways (see paragraph 48), a Settlement Corporation has been established to take over the railway's long-term debt which could not be transferred to the regional companies, which would be repaid from the sale of land no longer needed by the industry and of the shares of the regional companies, as well as to help retrenched workers to find new jobs. In addition, there may be environmental aspects to be considered. At the same time, because of their importance in the national economy and of the vital economic and social services which they provide, there is greater pressure than in a commercial privatization to show the benefits of privatization, as reflected in the supply and quality of services, their prices and in their economic impact (for example, on communications and other enterprise costs).

91. In view of the size of the transactions involved relative to the size of the domestic capital markets or of domestic savings, some countries may find it difficult to transfer full or majority ownership of infrastructure companies to the private sector through public offerings. However, there are other options, including minority ownership transfer, commercialization, corporatization, the granting of an operation and maintenance contract or joint ventures. Where there is genuine competitive bidding for the franchises, contracting out can provide periodic competition for the industries concerned. A non-divestiture option, which can also serve as a preparatory step to divestiture, is corporatization; such an option has been used effectively in some developed and developing countries (Australia, Malaysia, New Zealand and the United Kingdom) in order to prepare public utilities for their successful transfer to private ownership.

92. Another option still is the sale of development and operating rights through build-operate-transfer schemes. While such an option can provide a number of benefits, e.g. new sources of capital, reduced time and cost to develop new infrastructure, improved operating efficiency and responsiveness to customers, efficient pricing of infrastructure services, and new tax revenues, there can be major obstacles, including the reluctance of financial markets to finance infrastructure projects without Government financial support or guarantees, lack of sophistication on the part of public managers to attract privately-financed infrastructure projects, and local opposition and environmental regulation. The latter affect both public and private projects. Although infrastructure development is costly, the cost of under-supply of a vital service like electricity, when translated into macroeconomic constraints to growth, may be much higher.

93. Governments may thus have to assume some of the risks and offer incentives to the private investor by providing a long-term contractual concession and, where necessary, monopoly power during the period of the concession, in order to attract financing for infrastructure development. Alternatively, Governments may choose a method whereby the risks are assumed by the private investor and are reflected in the tariffs. If subsidies are to be granted, they should be provided in a transparent manner. Loan guarantees

from multilateral agencies or the sponsoring Government may also be necessary in order to obtain the necessary financing.

94. Economic regulation is needed both to protect consumer welfare and to provide a guarantee and financial stability to the private sector developer-operator. Where the regulatory capacity is inadequate or is subject to political interference, a negotiated contractual concession, by covering the life cycle of the project, may be preferable to the private sector developer-operator than price or rate of return regulation. Such a contractual agreement between shareholders and the Government can stipulate allowable rates of return; it can provide for re-negotiations where the stipulated rates of return are not sufficient, as well as for penalties, for example when there are quality shortfalls.

95. Competitive bidding is necessary for the award of concessions. For this purpose, pre-selection of bidders is essential. There may be a role for the donor community to reimburse partially the pre-selected bidders for their bidding costs and to co-finance the cost of feasibility studies in order to enhance the participation of bidders in developing countries.

4. Contracting out of public services

96. The contracting out of public services to the private sector is used by a number of countries and particularly by the United States of America where it is the predominant method of privatization. It combines the private provision of public services with competition. Such competition can spur improved public provision of services. Where competition is active and where there is genuine competitive bidding for the franchises, it can lead to the provision of competitive services in terms of price and quality. For hard-pressed State or local authorities, faced with budgetary constraints, it can provide a useful additional source or an alternative to public provision. However, effective competition is essential in order to prevent collusive bidding or the emergence of dominant firms which may eventually shut out other competitors. There may be a need to monitor the quality of the services provided.

5. Particular conditions attached to privatizations

97. Special conditions are sometimes attached to sales, such as the retention of a special or "golden share" by the Government in order to protect the business from an unwelcome take-over, for example on national security grounds, or to provide an opportunity for the management to adjust to the private sector culture. The Government's practice of keeping a "golden share" in the telecommunications industry after privatization has been adopted in a number of countries (as in New Zealand, Turkey and the United Kingdom). In France, for reasons of national interest, the Government can take a particular action ("golden share") which would give the State the possibility, after a privatization exercise, to authorize any participation exceeding 10 per cent of the shares. After the modifications introduced in 1993, the share of control may be less than 10 per cent. However, the State retains the right to name one or two non-voting members to the Board of Directors of the company or to oppose any transfer of assets likely to jeopardize national interests. In the case of PEs operating in the area of health, security and defence, any participation exceeding 5 per cent of the share capital is subject to the

approval of the Minister of the Economy. Other similar measures allow the Government to place a State-appointed Director in a privatized company (Portugal, Turkey). In the Republic of Korea, in order to prevent investors from monopolizing the financial sector, ceilings are placed (maximum of 5 per cent for firms, maximum of 5,000 shares for individual investors) on the ownership of shares in the privatized banks. In the United Kingdom, any individual holding of shares of privatized utilities is limited to 15 per cent, regarded as the threshold for material influence on a company. Certain countries also place a limit on foreign equity participation (France, 20 per cent, but not applicable to EC nationals; Malaysia, 25 per cent). In addition, as indicated above, social conditions such as employment protection schemes are attached to sales in certain countries. Other conditions applied by certain Eastern and Central European countries include the development of export markets and share retention by the buyer for a specified period in order to prevent the buyer from quickly turning over the enterprise to another party. Likewise, in Sri Lanka, foreign investors are not allowed to transfer a recently-acquired enterprise to another foreign investor without Government approval.

98. In New Zealand, in order to promote widespread ownership and to avoid situations where minority shareholders of companies would object to their sale (as was the case with the Bank of New Zealand and the Petroleum Corporation), new owners are required to float shares as a condition of sale. For example, in the case of the Telecommunications Corporation, now privately owned, 40.1 per cent of the shares had to be floated by the new owners within three years of the sale. Similarly, a public flotation of 30 per cent of the shares was part of the Air New Zealand deal in 1988.

D. Privatization plans

99. Many countries have some annual plan for privatization, listing the enterprises approved for this, although enterprises not on the list may be added, if necessary, subject to the normal approval procedure. Some of these plans are quite elaborate. In Bulgaria, for example, the annual privatization plan indicates the minimum objectives, the minimum number of PEs to be privatized, the priority sectors, the proceeds of privatization and their use, privatization-related expenses, etc. It is accompanied by a list of the PEs to be privatized in which changes may be made in terms of additions or deletions.

100. In Egypt, a six-year privatization plan for the period 1991/1992 to 1996/1997 has been established, with the target of privatizing at least 25 PEs per year over the plan period. So far, 85 PEs have been identified for the first three years of the plan. Malaysia's Masterplan sets out the broad policy framework for privatization, including the objectives to be achieved, and discusses the main issues of privatization. The Masterplan has been widely publicized, and has helped to prepare the ground for the successful privatizations which followed. Its formulation was based on a large sample of PEs. Out of the 424 entities studied, 246 were considered privatizable. However, not all of them will be privatized. The Masterplan included the first Privatization Action Plan for 1991-1992, designed to help channel efforts to priority areas in a more systematic and organized manner in consonance with national macroeconomic policies and the development strategy, thus enabling

the privatization programme as a whole to acquire momentum and credibility. The Action Plan, updated each year after an end-of-year review, is a two-year rolling plan, giving details of the PEs to be privatized and of those to be prepared for privatization.

E. Organization of privatization

101. The organization of privatization includes three aspects: the adoption by Parliament of the enabling legal framework and legislation for specific privatization programmes; the taking of decisions on actual transfers and their terms either by Parliament itself or by a designated body; and the organization, coordination and implementation of the process.

102. The decision-making authority reviews and prepares privatization programmes for approval by Parliament. It usually decides on the actual transfers and their terms. In certain countries, it may intervene in important areas, for example, state banks or large mining companies (as in Ghana) or with regard to assets exceeding a certain value (Bulgaria). Such an authority is often the cabinet (Bulgaria, Ghana, Portugal, Malaysia) or the Prime Minister himself. The latter is true of countries like Egypt (where the Prime Minister also assumes the portfolio of Public Business Sector Minister) and Tunisia (where the Prime Minister also presides over the Commission in charge of privatization). In Finland, the Parliament itself decides on sales upon the recommendation of the Ministerial Committee for Economic Policy. In Portugal, Parliament retains the power to intervene if the legal documents prepared by the Government do not conform to the enabling legal framework established by Parliament. In France, decisions on the timing of privatizations are taken at the level of the Prime Minister, while the terms of privatization are drawn up by the Minister of the Economy upon the advice (of a binding nature) of an independent Privatization Commission, for example concerning direct sales or the minimum value of an enterprise.

103. In addition, a central body assumes policy responsibilities for the coordination of the privatization process. This can be a Ministry or Minister (as in France, Greece, Hungary, Poland and Portugal), a Commission, Committee or Council (Brazil, Ghana, Lithuania, Morocco, Nigeria, Pakistan, the Philippines, the Republic of Korea, Senegal, Thailand and Tunisia) or an Administration or Agency (Bulgaria, Egypt, Germany and Turkey), a Unit in the Prime Minister's Department (Malaysia), an Investment Bank (Jamaica), an Investment Fund (Venezuela) or a Development Fund (Slovenia).

104. Responsibilities for implementation are sometimes vested in the same central body (Bulgaria, but only for assets beyond a certain value, France, Germany, Greece and Jamaica). However, in some other countries, they are assigned separately to a Minister (Morocco), a Ministry, together with regional privatization agencies (Lithuania), or with an inter-departmental Committee (Tunisia), individual Ministries on a sectoral basis, working together with the central body (the Philippines, Poland and Portugal), a specially-designated Agency or Council (Hungary and Turkey) or to financial institutions (Nigeria). In Hungary, the State Property Agency, as a seller of State-owned property, is vested with powers to act like any other traders on the market. Where implementation is decentralized, the technical tasks related to the preparation, including valuation, and modalities of sale, of

enterprises to be privatized are shared among individual Ministries, sometimes with the involvement of the enterprises concerned. In Morocco, an independent Valuation Authority has been set up to prepare valuations of firms for the use of the Transfer Commission, the central privatization authority. In Portugal, advice on legal and technical aspects is provided to the Ministry of Finance, the central privatization body, and the cabinet by an independent Privatization Commission appointed by the Prime Minister. External consultants are often used in the preparatory stage, for example, foreign accounting firms to help with the valuation of enterprises and merchant bankers to advise on the modalities and terms of sale. In some countries like Bulgaria, external consultants have also been used for sector-specific studies.

105. Thus, there are variations among countries concerning the centralization or decentralization of implementation responsibilities. In Jamaica, after having had a long experience of decentralizing implementation responsibilities to individual Ministries and Departments, the authorities have decided to centralize both policy and implementation responsibilities in one entity under the direct responsibility of the Prime Minister, namely the National Investment Bank of Jamaica. Such an arrangement is seen to have a number of advantages: (i) it avoids the "fragmented" approach of the past and ensures that privatization activities are better controlled and monitored; (ii) economies of scale can be achieved through the central hiring of all consultants needed under grant-funded contracts and the use of a core of experienced privatization personnel for the coordination of divestment activities; and (iii) centralization allows for greater use of consultants so that more transactions can be accomplished simultaneously. However, there are arguments in favour of decentralization, including speed of implementation and reduced workload on the central coordinating authority. The answer will depend on where the balance lies between cost efficiency and speed, with its costs and benefits, in each particular situation. In any case, even with decentralization, the central authority will need to supervise the process in order to ensure that the objectives set are met and that there are no abuses.

F. Information, promotion and marketing techniques

106. Special importance has been attached by countries to creating public awareness of the importance and objectives of privatization, promoting transparency and accountability, as well as marketing efforts in order to achieve successful sales both at home and abroad. Transparency is one of the axioms of privatization policy in practically every country, although some countries went through a learning process before accepting it. In certain countries, the law requires that advance announcement and publicity be given to public share offerings (Portugal). Generally, countries adopt a two-pronged approach, one of a general nature designed to educate the public and to built up support for the process, and the other of a company-specific nature targeted at potential investors both at home and in foreign capitals. Both are part of an important marketing exercise to promote the value of privatization to all the parties concerned and the value of specific enterprises. If done effectively, it can not only help to build up a broad-based consensus but also to add real value to the assets being sold.

107. The former may consist of televised discussions, newspaper articles, information booklets and workshops and conferences organized with the help of

universities and research institutes on the issues of privatization, including its objectives, its effect on the economy, its social implications and so on. This public consciousness campaign has been organized in a number of countries (Bulgaria, Jamaica, Ghana, Morocco, Turkey); and has been conducted over an extended period prior to the launching of the privatization programme itself (Sri Lanka). In Nigeria, the privatization agency conducted a nation-wide tour to inspect the PEs earmarked for privatization and to hold discussions with public leaders, enterprise managers, employees and other members of the business community.

108. Transparency concerning sales is promoted through newspaper articles in the national, regional and international press giving details of sales, the bidders, their bids, the successful bid and the amount achieved (Ghana). Privatization operations are preceded by publicity campaigns in the media, which also give details of tenders and of sales (Portugal). Likewise, in the Netherlands, share flotations are preceded by intensive advertising campaigns at home and abroad.

109. Company-specific promotional efforts involve national and international advertising, direct mailing of information material to potential investors, as well as soft loans to investors or favourable prices and payment methods for the sale of firms in regions given priority in development (Turkey). They are targeted at potential investors, including employees who benefit from special advantages (Morocco)

110. In Argentina, after agreement was reached on which PEs should be privatized, information has been provided in order to attract potential investors. Offers have helped to determine what could be expected. Thus the package has been developed not in isolation from the market but by taking into account the interests of potential investors. Company- and region-specific exercises have also been undertaken, e.g. visits to Belgium (for the EC), Japan and the United States (for the North American market). Company or sector-specific seminars (e.g. on gas) have been held as part of the marketing campaign.

111. In Germany, special importance has been attached to transparency and marketing, including regular public offers of SMEs, selected according to branches; sales on the basis of a catalogue offer for small-scale enterprises (up to 50 workers) organized by savings banks and local communities; the standardization of sales, terms and conditions; offer of firms on so-called "firms stock exchanges", allowing a broad range of SMEs to participate; special efforts to attract the interest of foreign investors, including the use of international publications; the establishment of branches of the Treuhandanstalt in world trading centres such as Tokyo, New York and London; and participation in international trade fairs and expositions (leading to the sale of over 500 firms to foreign companies and fetching investments of around 15 billion DM).

G. Financing of privatization

112. The financing of privatization raises a number of issues relating to the mobilization of resources, both internally and externally, and the policy and institutional constraints thereto. As regards the raising of domestic

resources, the broadening and deepening of share ownership, including giving priority or preferential treatment to small investors (as in France, Jamaica, the Netherlands, Nigeria and the United Kingdom), a fixed percentage to nationals, with minimum and maximum subscriptions (30 per cent in Sri Lanka, 40-60 per cent in Nigeria), a fixed tranche to workers (10 per cent in Argentina, France, Nigeria and Sri Lanka and per cent in Poland), and schemes or incentives for the promotion of employee share ownership (Côte d'Ivoire, Sri Lanka) have been used as instruments not only to promote "popular capitalism", or "labour capitalism" for employees, but also to provide an alternative investment outlet to non-productive uses (such as hoarding gold), and thus to raise savings for productive investment. Consequently, the number of shareholders has increased in many countries. Where large-scale privatizations have taken place, the number of investors has increased quite dramatically, e.g. from 3 million in 1979 to 10 million in 1992 in the United Kingdom, and from 1.5 million in 1986 to 6.5 million in 1989 in France. Whether there has been a significant privatization-led capitalization of idle resources, and whether there have been sustained capital gains of the shares of privatized enterprises, leading to increased discretionary income and savings, are questions that can only be answered empirically. What is clear, however, is that the public offerings of shares of privatized companies on the capital market, together with the broadening and deepening of share ownership, have in many cases led to significant increased capitalization and handling capacity of the stock market, rendering it more attractive internationally and making it easier to achieve successful share flotations. In these countries, there is no shortage of domestic buyers and, more often than not, the shares of privatized enterprises are over-subscribed many times over. A well-developed capital market can in fact have an important bearing on the structure, speed and implementation of the privatization programme.

113. Another important form of financing has been the mobilization of institutional savings. Chile, by privatizing the State pension system and associated life insurance companies, created the first group of institutional investors in Latin America. The privatized State pension system helped to finance the third successful phase of Chile's privatization programme starting in 1984, which covered the country's largest PEs, and to counter the notion that privatization benefitted only large foreign corporations. Private pension funds have also played a major role in the privatization programme of Brazil.

114. However, important problems remain for many countries in terms of achieving successful privatization sales. These include the problem of raising capital domestically for the sale of large-scale enterprises (as in Ghana, Peru, Poland, Senegal, Turkey and the United Republic of Tanzania) due to the low level of savings or of discretiona income, the limited number or interest of investors, the limited size or rudimentary nature of financial markets or the absence of a secondary market for company shares (which discourages small savers from acquiring shares). Various countries are taking steps to strengthen their financial markets so that they can play a leading role in the privatization process by providing long-term equity finance and a wide base of chare ownership (Côte d'Ivoire, Ghana). Meanwhile, in some of these countries, foreign investors, sometimes in partnership with domestic firms, have been the main buyers of privatized large-scale enterprises (Ghana, Peru).

115. The strengthening of financial markets and institutions is a matter of priority concern for many developing countries and countries in transition. Privatization, by rebalancing the public and private sectors, requires that the financial markets and institutions be expanded for private sector development, since the privatized firms will not have the same privileged access to Government loans previously available to them as PEs. For this purpose, and particularly where capital markets are thin, the number of potential investors is limited and the level of mobilized savings is low, greater attention needs to be given to the development and improvement of the network of financial intermediation, including informal linkages, in order to improve the mobilization of domestic savings so that additional credit creation to meet the financing needs, particularly of SMEs (which may have less equal access to credit than their larger counterparts), can be achieved without inflationary consequences. Their development in the countries in transition can help to tap the "monetary overhang" in such countries in order to raise resources in support of privatization and enterprise development.

116. Due to their limited domestic financial market, many countries allow, or actively encourage as a major objective of their privatization policy and through their investment code, foreign participation in the privatization of their PEs, through joint ventures or by allowing foreign investors to acquire privatized assets, including ownership of majority shares (as in Sri Lanka). In Argentina, some 60% of the assets sold to date have been bought by foreign investors from 19 countries. An important policy consideration is the recognition that foreign participation brings with it not only capital, but often also management skills, new technology and global or international linkages. In Malaysia, for example, while a limit is placed on foreign participation in the equity of a privatized company, this is permitted where: the expertise needed to improve efficiency is not available locally; it is required to promote exports; the supply of local capital is insufficient to absorb the shares offered; and the nature of the business requires global linkages and international exposures. However, certain countries seem to have failed to attract foreign capital. In Niger, for example, all the privatized companies have been sold to domestic investors.

117. In order to improve the financing of privatization projects, investment funds have been set up in a number of countries. In Morocco, an investment fund, INTERFINA, has been established as a joint venture between three Moroccan banks, together with two foreign banks and the International Finance Corporation, to provide financial support for privatization projects. Likewise, in Senegal, a private investment company has been established grouping the creditors of the State to allow the creditors to swap their loans for the equity of privatized companies. Turkey is examining the possibility of establishing a Fund for the Encouragement of Employee Savings in order to promote wide share ownership by investing 15 per cent of such savings in the share capital of privatized enterprises and other highly liquid assets. It has also launched a new financial instrument in the form of revenue sharing certificates of a Public Participation Fund which will allow the holders to benefit from the investments of the Fund in the development of infrastructure and regional projects, including the revenue of toll highways, power stations and other infrastructural facilities financed by the Fund.

118. Internal privatizations (sales to management teams or employees) are used as another source of financing in the countries in transition. However, since they require only a certain amount of cash immediately, additional capital and other inputs may be needed. Investment funds adapted to their particular situations have also been established in some of these countries, some created by private agents (as in the Czech Republic and Slovakia), some by the Government (Poland) and a mixture of both (Romania), in order to facilitate the transfer of the ownership of PEs to large segments of the population. These are basically operating as holding or management companies for the PEs concerned. Whether they will evolve into the type of investment funds which exist in OECD countries and elsewhere, capable of mobilizing small savings for investment in corporate capital, as the household discretionary income in these countries grows, remains to be seen.

119. The management of large-scale privatizations is important in order not to destabilize the capital market by "crowding out" private sector investment demands and raising the long-term cost of finance. The share issues of such privatizations are often large compared to other equity issues and thus exert a heavy demand on private sector financial resources, which calls for a greater role for the various financial intermediaries and the stock market in mobilizing both debt and equity capital. Such mobilization would not only facilitate privatization but also promote further development of the capital market. In France, a total of FF 83 billion was raised in the 1986 privatization programme. In order to reduce the risk of "crowding out", this amount had been largely "recycled" on the financial market through the alleviation of State debt.

H. Role of multilateral institutions and bilateral donors

120. A number of countries have reported receiving various kinds of assistance relating to different aspects of the implementation of their privatization programmes from both multilateral financial institutions and bilateral donors. Among the multilateral financial institutions, the World Bank has provided various kinds of loans, for the financing of structural adjustment programmes and the setting up of privatization agencies in many African countries, a social fund (Colombia) and a severance payments and voluntary retirement programme (Argentina). It has also provided technical assistance on the formulation of a privatization strategy for 15 large-scale infrastructure-related PEs (Thailand). Its private sector lending agency, the International Finance Corporation, has joined with two foreign banks and three Moroccan banks to establish an investment fund to support the privatization process (Morocco). The African Development Bank has helped the Government to set up a fund, together with part of the proceeds of privatizations, for the promotion of small- and medium-sized enterprises and industries (Senegal). The Inter-American Development Bank has financed privatization studies (Venezuela). The United Nations Development Programme (UNDP) has financed technical assistance, training and the purchase of equipment and part of the public relations campaign related to the privatization programme (Morocco). The EEC-PHARE programme has financed the services of foreign experts, advisory and consultancy services, as well as training and marketing activities (Poland).

121. Among the bilateral donors, examples of assistance include the grant aid provided by the Overseas Development Administration (ODA) of the United Kingdom for strengthening the secretariat of the Divestment Implementation Committee (Ghana); financing provided by a German donor agency for a privatization study of a particular PE (Ghana); privatization-related support provided by Canadian and German donor agencies (Morocco) and similar support provided by Canadian and French donor agencies (Poland, Senegal). The United States Agency for International Development (USAID) has financed valuations and audits of PEs (Morocco), technical specialized services not available in the National Investment Bank of Jamaica, the privatization agency, and the administration of a Jamaican Privatization Guarantee Facility (Jamaica). It has financed the training of Government valuation experts (Sri Lanka), sectoral studies, accountancy services and training (Poland) and valuation and strategy studies and marketing services (the Philippines). A Danish corporation, the Danish Industrialization Fund for Developing Countries, has provided equity, and to a lesser extent loan capital, to several privatized enterprises in Togo, where its financial participation was crucial in attracting private Danish firms to become partners in such enterprises.

122. These examples are indicative and there are many other instances of assistance, including those mentioned in statements to the first session of the Ad Hoc Working Group, and in subsequent replies sent in response to a request from the secretariat and made available to the Working Group, by a number of multilateral financial institutions, including the World Bank, the Asian Development Bank, the Inter-American Development Bank and the European Bank for Reconstruction and Development, as well as by other international or regional bodies such as UNDP, OECD, the Commonwealth Secretariat and the Andean Group.

I. Environmental issues

123. Environmental issues have been raised in the country presentations in terms of the environmental burdens of privatized or privatizable PEs in the eastern part of Germany, where 90 per cent of such burdens are absorbed by the Treuhandanstalt, and in some of the countries of Eastern and Central Europe (as in Bulgaria, where the improvement and protection of the environment is one of the objectives of its privatization policy), as well as in terms of environmental standards that may impact on privatization and of the manner in which they are being addressed.

124. In Jamaica, environmental concerns and standards are increasingly becoming an important part of privatization projects. Thus, where such projects involve major environmental considerations, one of the criteria used in the assessment of a proposal is whether it includes measures to ensure that the privatized company operates, as far as possible, in an environmentally-friendly manner. For example, where projects have a large chemical component or waste content (as in a textile or distillery factory), an environmental impact assessment is undertaken in order to identify the problems with regard to the company's operations and to propose possible solutions. In addition, the Natural Resources Conservation Authority, a Government agency, ensures that companies operate in conformity with good environmental practices and that privatizations incorporate such practices.

125. In Poland, an inter-Ministerial Environmental Unit has been established to deal with environmental issues arising from the privatization process, particularly those relating to liability and compliance. Among its principal objectives are to evaluate and propose relevant legislation and regulations, to obtain the necessary environmental data on companies to be privatized, to oversee environmental audits and to monitor the buyers' contractual obligations concerning the environment.

126. In the United States, environmental considerations have not been a major issue for the contracting out of municipal services. Private service providers must comply with the same environmental laws and regulations as are applied to public providers and are subject to fines for non-compliance. By contrast, environmental regulations have been a barrier to private infrastructure development. Infrastructure facilities must undergo a rigorous environmental permitting process before construction can begin. This increases project costs and risks and can impair the ability to attract private financing.

V. SOCIAL IMPACT

A. Social effects

127. Social considerations are an essential component of the process of privatization and need to be built into the process from the beginning and reflected in the strategy for privatization. Different groups of people are affected by the privatization process, including workers, managers, technocrats, consumers, etc. Their concerns need to be addressed through appropriate consultations and through regulation to protect consumer welfare.

128. The social balance sheet of privatization goes beyond the effects of privatization on employment and consumer welfare. It will also have to address the effects of privatization on investment and growth, income and wealth distribution, and the provision and cost of infrastructure and social services arising from the privatization of public utilities and social services. However, for the purpose of this paper, and in the light of the information received, this section will focus on the employment aspects relating to the privatization of PEs. Thus, it covers essentially only one aspect of the social balance sheet and in a rather limited way.

129. As far as employment is concerned, privatization can have both positive and negative effects. In the short term, the positive effects include improved terms of employment for managers and workers kept on the company's payroll after privatization (as in Jamaica), and access, sometimes free of charge, to a proportion of the shares of the new company (an axiom of privatization policy in many countries). In the Netherlands, for example, privatization often leads to salary increases for managers and lower salaries for lower personnel. To soften the impact, a temporary net salary guarantee for the latter is normally provided. In the longer term, there may be employment gains resulting from increased investment and growth of the privatized companies.

130. The major negative impact is labour retrenchment linked to privatization. It should be noted, however, that retrenchment may also arise from other kinds of enterprise reforms, including commercialization and corporatization. In fact, it is often argued that since the Government is in a

better position to handle surplus labour, it may be preferable to slim down a PE during corporatization before it is sold. Further, the overall impact on individual workers will depend on the benefits received, including severance payments, early retirement benefits, job placement, counselling and training services, as well as alternative employment opportunities, including self-employment through the setting up of businesses. Thus, the impact of retrenchment may be attenuated by privatization-induced socially-related support measures and may be offset by alternative employment opportunities, including those arising from job-creating growth of the privatized companies or of other enterprises stimulated by the privatization process. Moreover, such retrenchment is not part of an inevitable logic of privatization. Some countries have had no adverse employment consequences because privatization took place in a favourable employment market (Portugal). Others have used privatization policies to protect employment in the privatized firms for a specified period after privatization, ranging up to five years (Malaysia, Morocco, Pakistan, Sri Lanka). In Japan, out of 92,000 workers affected by the privatization of the national railway company, 32,000 were absorbed by the new companies, 20,000 took voluntary retirement, 30,000 were transferred to the Settlement Corporation which had to find alternative employment for them within three years and 10,000 were re-trained and found jobs in private sector companies eligible for job-creation subsidies. Further, increased investment in the privatized enterprises or their improved performance has generated new jobs (Jamaica and the Philippines). In Sri Lanka, one of the first privatized companies, a textile mill, benefited from increased investment, enabling the company not only to absorb the surplus labour but also to create many new jobs. Likewise, in the western part of Germany, improved performance, including better management, has led to increased employment in two major privatized industrial groups, VEBA, from 74,597 in 1987 to 116,979 in 1991, and VIAG, from 33,427 in 1988 to 74,122 in 1991. However, in a number of countries in Africa and elsewhere, there has been a serious negative impact on employment. In the eastern part of Germany, 3.5 million out of a total 9.5 million jobs were lost, leading to 30 to 40 per cent unemployment or under-employment in some regions.

B. Socially-related support measures

131. Socially-related support measures designed to soften the negative social impact of privatization are part of the "social provisions" of the privatization process. Success in designing and implementing them can be crucial for ensuring the credibility and success of the process itself. The following quotation from the Netherlands contribution can also apply to other support measures: "Creating a social safety net calls for clear principles to be established from the start; these might be set out in a social plan; these principles should be established as early as possible in the privatization process in order to secure the cooperation of all the staff. There is a general tendency at the start of a privatization operation to under-estimate both the costs and the time involved".

132. Such support measures include, *inter alia*, redundancy or severance payments (as in Argentina, Ghana, Germany, Greece, Sri Lanka, Tunisia, Turkey, Venezuela), voluntary early retirement schemes (Argentina, Venezuela), retraining or vocational training (Benin, Colombia, Ghana, Japan, Portugal, Turkey, Venezuela), the promotion of entrepreneurship and the setting up of

micro, small or medium-sized enterprises (Colombia, Ghana, Jamaica, Senegal, Tunisia and Turkey). Germany has, in addition to vocational training, used early pension schemes, public work programmes and short-time working as part of a massive labour market policy to reduce unemployment in the eastern part, reducing its average rate to 16 per cent (compared to 30 to 40 per cent in some regions).

133. In some countries, the institutional support for job retraining and the promotion of entrepreneurship already existed (Ghana, Portugal). In some other cases, institutional support for retraining and/or entrepreneurial and enterprise development has been linked to privatization and provided by a fund established for the purpose (the Philippines, Tunisia); established with the help of a loan from a multilateral financial institution (Colombia); and established with such help, together with part of the proceeds of privatization (Senegal). Part of these proceeds has been used to finance end-of-service payments (Ghana) or will be used to finance a social fund (Bulgaria). In some cases, retraining of labour made redundant by privatization is handled by the focal point for privatization (Benin). In Germany, the Treuhandanstalt takes care of the financing of the necessary social plans in connection with any staff retrenchment.

134. As stated above, in some instances, the proceeds of privatization have been used to varying degrees to finance redundancy or severance payments or support for the development of entrepreneurship and of SMEs. They have also been used to invest in education and in physical infrastructure (Mexico, Venezuela). The question that arises is to what extent such proceeds should be used to finance job-creating measures in order to soften the negative social impact of privatization, as well as to invest in human resources development and other assets conducive to growth and job creation, as opposed to other uses. This matter is related to the importance of providing institutional support for the development of entrepreneurship and of micro-enterprises and SMEs as a supplementary measure not only to ensure the success of privatization but also to make full use of the experience and skills of redundant workers for the economic development of the country. In this connection, it is worth noting that, in Venezuela, the Privatization Act provides that no less than per cent of the proceeds should be devoted to technical innovation, industrial development and the development of micro-enterprises and SMEs and that no less than 15 per cent should be devoted to technical education and vocational training.

135. In Tunisia, particular attention has been accorded to the redeployment of the excess personnel which has acquired experience beneficial for the economic development of the country. Thus, in addition to the payment of indemnities, the employees released are given help and the necessary institutional support in order to enable them to set up small businesses which can themselves generate employment. This pragmatic approach represents the most important positive aspect in the sense that the first phase of privatization has been realized without social problems and sometimes even with the support of employees.

136. Strengthened institutional support for SMEs may be necessary in order to ensure the vitality of such firms, themselves generated by the privatization process, and the success of the process itself since they play a key role in

fostering competition and in generating employment. Such support may comprise measures, including regulatory and fiscal reforms, to help them in a number of areas, including their access to finance, technology, government procurement, marketing and distribution channels, as well as information, training and advisory services. Assistance to entrepreneurs in the informal sector, including support for their access to credit and for their graduation to the formal sector, can contribute to job creation and to improved competition and tax revenue for the State.

137. Like the developing countries mentioned above, some of the countries of Eastern and Central Europe and of the former Soviet Union have taken or are taking measures, including the adoption of laws, to stimulate further development of the small business sector (as in Bulgaria and Lithuania). However, many obstacles remain, including lack of start-up finance, gaps in legal framework, unequal application of laws and bureaucratic inertia in business registration, lack of marketing, financial accounting and other management skills or information about basic business practices (Lithuania).

VI. RESULTS OF PRIVATIZATION AND THEIR EVALUATION

A. Assessment of results

138. Specific privatization objectives have been elaborated at various levels. In some countries, indicators for evaluating the achievement of these objectives have been specified (as in Portugal). Further, various types of results arising from privatizations have been reported. In some cases, the machinery for monitoring and evaluating the results of privatization programmes has been established. However, such evaluation machinery or procedure has still not been widely adopted, perhaps because there has not been a sufficiently long experience of privatization in many countries.

139. The responsibility for monitoring and evaluating the results of evaluation is vested in the Prime Minister's Department (Turkey) or the Ministry of Finance (Portugal). In France, the results of the 1986 privatization programme have been evaluated by the State Accounting Authority (Cour des Comptes), a parliamentary commission and the Superior Council of the Public Sector. In Venezuela, a Coordinating Bureau has been established to assess the impact of privatization. In Jamaica, an independent evaluation of the results of privatization has been conducted by a noted Jamaican political scientist.

140. In Portugal, the Ministry of Finance has specified evaluation indicators for each of the objectives. To quote a few examples, for assessing the performance of privatized companies, indicators used include the investment/employment ratio, in addition to standard indicators of profitability or of productivity. The percentage of privatized firms held by groups owned by nationals is used, among others, to measure the development of national entrepreneurial capacity.

B. Results of privatization

141. As regards the results of privatizations, it is recognized in some cases that it may be too early to make a systematic analysis and that the results of evaluation are not always quantifiable. Still, some assessments have been made.

142. According to the country presentations submitted to the Ad Hoc Working Group, there is evidence to indicate that properly-executed privatizations have yielded important benefits. These include, in relation to the objective of promoting economic efficiency, enhanced market competition in particular sectors (as in Malaysia, New Zealand and the United Kingdom); improved performance and competitiveness of privatized enterprises (Argentina, Greece, Jamaica, Japan, Morocco, the Philippines, Portugal); lower consumer prices charged by privatized firms and/or improved customer services provided by them (Japan, the Netherlands, New Zealand, the United Kingdom), expanded capitalization, investment and capacity of privatized companies, leading to greater security or growth of employment (Germany, Malaysia, Nigeria); improved access of privatized firms to capital, technology, skills and international linkages (Finland, Malaysia, New Zealand). Privatization has enlarged the circle of entrepreneurs (Jamaica); and increased the capitalization and handling capacity of capital markets (France, Malaysia, Nigeria, the Philippines, the United Kingdom). It has attracted foreign investment, including through joint ventures (Jamaica, where 94% of foreign direct investment in 1987 was privatization-driven, Peru, Sri Lanka, Turkey, Venezuela). It has brought about intangible benefits such as the introduction of the discipline of private sector culture in the management of privatized firms which continue to have a share of State ownership (the Netherlands, New Zealand). The very act of preparing a PE (a telecommunications company) for privatization and of selling a minority share (25%) of the enterprise has apparently had a positive effect on enterprise performance (Israel).

143. As regards the role of the Government and macroeconomic management, privatization has reduced the weight of subsidies to public enterprises (when loss-making enterprises have been sold off or when subsidies to public enterprises have exceeded the income foregone from such enterprises) as in Ghana, Jamaica, Malaysia, Nigeria and the Philippines. It has led to increases in government revenue (when the corporate taxes paid by privatized firms have exceeded the revenue previously received from them), as in Argentina, Malaysia and Nigeria. The one-off proceeds from privatization sales, very substantial in some cases, have enabled Governments inter alia to reduce long-term debt and budgetary deficits (Argentina, France, Portugal, the United Kingdom, among others) or to finance human resources and infrastructure development (Mexico and Venezuela), enterprise development (Senegal), agrarian reforms for the benefit of landless farmers (the Philippines) and environmental activities (Germany). The private development of infrastructure has provided additional sources of financing for some of the "core" activities of the State, thus reducing infrastructural bottlenecks, easing budgetary constraints or releasing resources for other development projects (Indonesia, Malaysia, Portugal, Thailand). Privatization, together with other measures, has contributed to macroeconomic stabilization and to the creation of a climate of confidence in the economy, leading to the return of flight capital in certain countries (Argentina). In the United States, contracting out arrangements have

realized important cost savings (10 to 40 per cent) in the provision of public services and produced other benefits, including higher quality services, as well as greater flexibility and shorter delivery time in the provision of such services.

144. However, these benefits have been achieved mostly in high or middle-income countries, sometimes at some social costs; and the efficiency gains such as lower consumer prices may have been due as much to the strengthening of competition, including that induced by privatization, as to ownership change itself. Further, in some low-income countries, privatization has been more difficult to achieve and, in some instances, privatization has been marked by the poor performance of the privatized companies, resulting in a loss of fiscal revenue and of jobs (as in Niger). Moreover, while privatization has broadened the base of share ownership in a number of countries (Argentina, France, Jamaica, Malaysia, the Philippines, the Republic of Korea, Sri Lanka, the United Kingdom), more research is needed on the income distribution effects. While a relative degree of success has been achieved in some of the countries of Eastern and Central Europe and of the former Soviet Union (Czech Republic, Lithuania and Slovakia), it remains to be seen how successful mass privatization will be as a means of sharing national wealth among the general population in these countries.

145. In these countries, where privatization is a core element of the transition to a market economy, the dynamics of the transformation process have a critical bearing on the privatization process. Most of them have recorded impressive results in terms of "small privatizations", particularly in services, retail trade and agriculture. However, the privatization of medium-sized and large enterprises in the manufacturing and banking sectors has advanced much more slowly than anticipated, even if the complexity of the task is duly taken into account.

146. Although these countries have approached privatization from different positions, consequently with a considerable variation in their privatization strategies, they have encountered rather similar impediments. Despite considerable progress in institution building, there are still gaps, particularly concerning the requisite legal instruments, access to finance and the functioning of the public administration. Macroeconomic conditions, in particular monetary and fiscal policies, have often lacked a supportive element for privatization activities. It has become evident that the skills and business attitudes acquired previously in the "shadow economy" are not necessarily sufficient for successfully running large-scale enterprises under market conditions. Further, deficiencies in basic infrastructure, particularly communications, have frustrated potential private investors. Moreover, political instability and uncertainty in some of these countries about the direction and depth of the transformation process have inevitably contributed to a slowing down of the privatization process when progress is needed in order to give it credibility.

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CONSIDERATION OF THE COUNTRY PRESENTATIONS IN THE LIGHT OF A CROSS-COUNTRY REVIEW BY THE SECRETARIAT OF THE DESIGN, IMPLEMENTATION AND RESULTS OF PRIVATIZATION PROGRAMMES

Issues relating to (a) privatization and the environment and (b) the privatization of pension funds

Note by the UNCTAD secretariat

CONTENTS

		Paragraphs
INTRODUCTION		1
I.	PRIVATIZATION AND THE ENVIROONMENT	2 - 22
	A. Introduction	2
	B. Impact of privatization on the environment	3 - 12
	C. Environmental management of privatization	13 - 21
	D. Concluding observations	22
II.	PRIVATIZATION OF PENSION FUNDS	23 - 48
	A. Introduction	23 - 25
	B. Nature of the reform	26 - 32
	C. Competition and regulation	33 - 35
	D. Effects on savings	36 - 39
	E. Financial and other reforms	40 - 43
	F. Concluding observations	44 - 48
NOTES		

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INTRODUCTION

1. This note discusses issues relating to two topics that were raised at the third session of the Ad Hoc Working Group, namely (a) privatization and the environment and (b) the privatization of pension funds. It is intended to serve as an aid for discussion by the Ad Hoc Working Group at its fourth session rather than as a full treatment of the issues.

I. PRIVATIZATION AND THE ENVIRONMENT

A. Introduction

2. Privatization raises a number of important issues concerning the environment and sustainable development. Some of these issues, relating to the environmental management or impact of privatization, are included in a number of country presentations submitted to the Ad Hoc Working Group. Further, a paper prepared by a research institute (Rogaland Research) in Norway and submitted by the Government of Norway to the Ad Hoc Working Group at its third session raises a number of issues with regard to environmental management and the relationship of privatization to growth and the environment. 1/ This brief note attempts to bring together some of the main issues under the aspects of the impact of privatization on the environment and of the environmental management of privatization.

B. Impact of privatization on the environment

3. Privatization can have an impact on the environment in a number of ways: for example, by creating industrial and market structures which attract foreign investment and technology, including environmentally sound technology; by creating competitive market structures which provide incentives for innovation and efficiency, including incentives to improve production processes and to produce products which are environmentally friendly, and which allow market-based instruments of environmental regulation to operate efficiently; and by forcing infrastructure services to align the prices of their outputs to their real costs and thus to cut out wasteful consumption and pollution due to underpricing.

4. The primary objective of privatization which is broadly shared by Governments is to promote competition and economic efficiency. Competition is in fact central to the success of privatization. One of the major lessons learned from privatization experiences is that, while ownership often matters, competition matters even more. This is true of public utilities, where pro-competition regulation is an important aspect of utility regulation, as it is true of competitive markets. Thus, where privatization contributes to competition and economic efficiency - and there is some evidence from the country presentations submitted to the Ad Hoc Working Group and other studies that privatization programmes in a number of countries have achieved efficiency gains in terms of increased competition and lower consumer prices 2/ - it can also contribute to eco-efficiency. Broadly speaking, eco-efficiency means production and consumption structures which minimize resource use and pollution per unit of output. In a technical sense, it means

ecological or "full-cost pricing", i.e. pricing of economic transactions or goods in a way which reflects or "internalizes" environmental externalities. 3/

5. In practice, whether privatization promotes eco-efficiency, for example by reducing pollution, can only be verified by reference to the evidence. There is, however, a "circumstantial case", as the World Bank puts it, that privatization is beneficial for the environment. To put it simply, public enterprises tend to pollute more because they use old technology, they often receive protection and they can more easily avoid compliance with pollution controls or get exemptions from pollution regulations. However, private enterprises can also increase pollution, because they may be more inclined to undertake polluting activities where profits are important, to bribe regulators or to hide information from them. 4/ In the final analysis, whether ownership matters depends on the manner in which competition and environmental regulation and pressure operate on public or private ownership. In this regard, reference may be made to a case study cited by the Norwegian paper of 26 pulp and paper plants in Bangladesh, India, Indonesia, and Thailand. The study explicitly deals with the relationship between ownership and pollution at the micro level. 5/ According to the study, the factors that are positively related to environmentally benign management are competitiveness, rural location of the plants (perhaps because the source of pollution is easier to identify than in urban areas) and the standard of living of the country. It concludes that ownership in itself does not seem to have any impact on pollution control. However, as most of the public enterprises were the least competitive, they also had less pollution control.

6. In theory, privatization, by improving industrial and market structures and attracting foreign investment and capital, which is one of the major reasons for privatization, can attract modern technology, including environmentally friendly technology. One example is water treatment technology for the privatization or expansion of water supplies. However, it can also bring in foreign capital to participate in projects, for example mining or large-scale irrigation, which can lead to environmental damage unless such activities are properly managed environmentally.

7. Further, where privatization succeeds in creating competitive market structures, the environment itself can become an instrument of competition. This is happening in a number of developed countries, but developing countries too can get into the act, for example by developing environmentally sound natural resource-based industries. In developed countries, there is evidence that companies in competitive markets, with an eye to increased environmental consciousness on the part of consumers and under pressure of environmental lobbies and regulations, are themselves looking for ways to improve their "green" image through environmental reporting and through the development of environmentally sound products in terms of improved energy efficiency or of reduced pollution in order to stay ahead of their competitors or to maintain market shares. Examples include electricity-driven cars, phosphate-free detergents and mercury-free batteries. Some companies in developed countries have also been able develop new export markets, for example for the environmentally friendly water treatment technology referred to earlier.

8. Competitive markets are also necessary if market-based instruments for environmental regulation are to work. Such instruments, because they rely on market forces and the competitive drive, may be more efficient than command and control mechanisms which are usually seen as an imposition. By reducing subsidies and introducing environmental taxation, they also have a number of fiscal advantages. One such market-based mechanism is a system of tradeable emission permits. In this regard, reference may be made to the market-based programme to clean up urban air pollution, which was introduced recently in Southern California. Under the programme, known as the Regional Clean Air Incentives Market (RECLAIM), industrial enterprises in four Los Angeles area counties are allocated an annual pollution limit and then granted the freedom to choose the cheapest way to achieve it. Companies that succeed in cutting their emission levels in relation to their limits can sell the excess credits for whatever price they can fetch, thus giving them an incentive to reduce pollution. 6/

9. Privatization, by forcing a privatized electricity company, for example, to charge consumers the real costs of production, can also help to reduce wasteful consumption and pollution due to underpricing. The latter may be due to historical reasons or to the fact that no conscious effort has been made to calculate the real economic costs until it is decided to privatize or to invest in new capacity because of supply shortages, as has occurred in some developing countries. The costs of inadequate supply, when translated into macroeconomic constraints to growth, may be much higher than the costs of generation and supply. If subsidies are to be provided, for example for particular social groups such as rural populations, that can be done in an explicit and transparent manner on the basis of the real costs.

10. In the commodity sector of developing countries, privatization and its benefits are closely related to the need to provide incentives for the economic agents involved to use the resources and to provide their goods and services in a sustainable way. The issue is of relevance both in agriculture, where the resources are renewable, and in the mining sector, where the resources are non-renewable. 7/ In many instances, the issue is closely related to property rights which do not exist or are not well defined, thus creating large externalities. In that situation, the market pricing mechanism does not reflect the environmental value of natural resources for the society as a whole. For example, there are cases where the absence of land titles has created a situation of open access goods and, thus, the farmers and other economic agents operate only in the context of their private costs and of their profit objectives, in disregard of conservation and other environmental objectives. In these cases, securing the land titles, in combination with other policy instruments, can improve significantly the way the resources are used. 8/

11. The Norwegian paper also takes up the relationship of privatization to growth (including the growth of consumption) and of the latter to the environment. The relationship will need further research and empirical verification, particularly as the efficiency gains of privatization would need to be disaggregated by different groups of countries according to their income levels. The paper makes the important point that "most success stories (of privatization) are from industrialized countries and middle-income developing countries (and that) it is more difficult to implement effective privatization

processes in poor countries, although there is sporadic evidence of positive results". Taking this as a starting point, it would seem appropriate to compare economic gains from privatization and other economic reforms with the environmental consequences of stronger economic growth in different groups of countries - industrialized, transitional-economy, middle-income and low-income developing countries. The answers from such studies will shed more light on the relationship of privatization to growth and the environment.

12. As regards the question of regulationary capacity to promote competition and to deal with market failures that lead to environmental problems, there may be a positive correlation between those developing countries undertaking successful privatizations and their competitive market structures and regulatory capacity. Further, how growth will affect the environment depends not only on growth itself but also on the quality of growth. To the extent that privatization leads to efficient industries and competitive market structures, so that competition and market-based instruments of environmental regulation can operate effectively, privatization can lead to increased economic and ecological efficiency, and thus to a higher environmental quality of growth. Thus, the issue raised is an important one, but needs to be further researched so that proper conclusions can be drawn that can contribute to action for the achievement of the objective of sustainable development, including in the areas of financial, technological, technical and other forms of cooperation.

C. Environmental management of privatization

13. The environmental management of privatization is an important part of the process of privatization. It deals with a number of important issues, including the environmental record and liabilities of public enterprises, the question of environment audits for such enterprises, how such liabilities can affect banks and other creditors and the extent to which the State should take over such liabilities when privatizing them; the elaboration of environmental policies and instruments and how such policies may be integrated with privatization policies; the issues of infrastructure and of environmentally sensitive sectors and the use of environment impact assessments; and the establishment of environmental standards and instruments of environmental regulation, as well as the role of the State in environmental regulation.

14. When public enterprises have a poor environmental record or are seen to have environmental liabilities, private investors may be reluctant to get involved lest they should end up with a large bill to clean up the environmental damage. Thus, potential liabilities for cleaning up soil contamination, together with uncertainties about emission standards, are known to have discouraged foreign investors in Eastern and Central Europe. Their transfer to the private sector, with their environmental liabilities or potential liabilities intact, may also have undesirable effects on the banking system to the extent that they have major loans with the banks. In such a situation, the State may have to absorb the environmental liabilities in order to be able to sell the enterprises. For example, in the eastern part of Germany, the policy of the Treuhandanstalt is to absorb some 90 per cent of the environmental burdens of privatized enterprises. For the potential buyers and the creditor banks, an environmental audit may also be necessary in order to establish what the true environmental liabilities are.

15. In order to take into account the environmental implications of privatization projects, and to provide for environmental regulation, environmental policies and instruments are needed. Further, environmental policies may need to be integrated into the privatization process, particularly in the case of the privatization of public utilities and of environmentally sensitive sectors such as chemicals or chemicals-based, extractive mining and forestry. Such integration will ensure that privatizations are evaluated from an environmental perspective and that an environment impact assessment can be made at the beginning of the privatization process. In Jamaica, for example, environmental concerns and standards are increasingly becoming an important part of privatization projects. Thus, where such projects involve major environmental considerations, one of the criteria used in the assessment of a proposal is whether it includes measures to ensure that the privatized company operates, as far as possible, in an environmentally friendly manner. For example, where projects have a large chemical or waste content (as in a textile or distillery factory), an environmental impact assessment is undertaken in order to identify the problems with regard to the company's operations and to propose possible solutions. In addition, the Natural Resources Conservation Authority, a government agency, ensures that companies operate in conformity with good environmental practices and that privatizations incorporate such practices.

16. Coordinating or consultative mechanisms may also be established in order to facilitate the integration of environmental policies into privatization projects. In Poland, for example, an inter-Ministerial Environmental Unit has been established to deal with environmental issues arising from the privatization process, particularly those relating to liability and compliance. Among its principal objectives are to evaluate and propose relevant legislation and regulations, to obtain the necessary environmental data on companies to be privatized, to oversee environmental audits and to monitor the buyers' contractual obligations concerning the environment.

17. The privatization of public utilities and of environmentally sensitive sectors deserve particular attention. In the case of public utilities, which are "natural monopolies" or which have monopoly sectors, environmental regulation is closely linked to economic regulation. For example, pollution control in electricity generation or in the disposal of sewage and waste water is part of environmental regulation. But it can also be part of price regulation designed not only to protect consumer welfare but also to provide an incentive for investment in environmentally sound technology.

18. Infrastructure facilities or projects which have important environmental implications need environmental impact assessments. Such assessments are in fact done routinely by the multilateral financial institutions for such projects financed by them. However, in practice, the costs and delays associated with detailed environmental assessments, together with problems with land use and compensation, can act as obstacles to the private development of such projects. 9/ In the United States, for example, infrastructure facilities must undergo a rigorous process to meet environmental requirements before construction can begin. This increases project costs and risks and may discourage private investment. However, the costs related to environmental assessments are the internalization of external

environmental costs, which make it all the more important that environment impact assessments should be made for such projects from the point of view of sound environmental management.

19. In the case of the private development of infrastructure projects such as roads and tunnels, the State and the private investor may also have conflicting objectives, with significant implications for the environment. For the State, while it will want to reduce the volume of traffic, it is in its interest to use a high estimate of traffic in negotiations in order to boost the project's profitability. For the private investor, while it will want a high volume of traffic in order to maximize the toll earnings, it is in its interest to use a low estimate in order to push for high toll rates.

20. Likewise, environmental objectives and policies will need to be taken into account explicitly in the privatization of environmentally sensitive industries operating in competitive markets. An environment impact assessment will be needed for each major privatization with important environmental implications. Such an assessment may also include international dimensions, including foreign direct investment and environmentally sound technology. In such a situation, market-based instruments or incentives can be used as a form of environmental regulation or of internalization of environmental costs, including taxes. Environmental standards will need to be established and procedures defined for their enforcement. For air polluting industries operating in competitive markets, tradeable emission permits may also be used.

21. Where the market is competitive, environmental regulation by market-based instruments such as taxes may be more effective than command and control mechanisms, which involve direct regulation by the State. However, whichever method is used, an efficient public sector is needed in order to devise and implement appropriate environmental policy instruments, including standards setting and monitoring of their compliance.

D. Concluding observations

22. Privatization, by contributing to industrial restructuring, competitive market structures and economic efficiency, can contribute to ecological efficiency. It can do so by helping to reduce wasteful consumption and to improve access to capital and new technologies, including environmentally sound technology. By contributing to competitive market structures, privatization also contributes to market-based mechanisms as a form of environmental regulation and to market-based incentives for the development of environmentally friendly production processes and products. Under competitive market conditions and under the pressure of environmental concerns, the environment can become an instrument of competition. Market-based instruments may be more efficient than command and control mechanisms as tools of environmental regulation. Whatever methods are used, an efficient public sector is needed for formulating environmental policies and standards and for monitoring their compliance. Environmental policies need to be linked more explicitly to the privatization process at an early stage, particularly for the privatization of infrastructure and environmentally sensitive sectors, for which environment impact assessments may be needed. Economic regulation is needed for monopolistic sectors; environmental regulation may be linked to it in such sectors.

II. PRIVATIZATION OF PENSION FUNDS

A. Introduction

23. The drive towards reform of State pension systems has been spurred by various factors. In the developed countries, the major concern has been the increasing gaps between contributions and payments due to demographic factors (lower support ratio of working-age to retired age people), the design and structure of the pension systems themselves (leading to over generous defined benefits in relation to the contributions), the effects of the recession on employment, fraud and the use of pension fund reserves for financing fiscal deficits rather than future pension liabilities. Some of these problems have also arisen in some developing countries. In some other developing countries, however, the major concern has been to extend social insurance in terms of increasing both the level of pension benefits and the population and contingency coverage. These different concerns have led to different types of reforms. While some developing countries, such as Chile, have moved from pay-as-you-go systems (PAYG) to privately-managed individual capitalization schemes, other developing countries like Ghana have moved in the opposite direction, from State administered individual capitalization schemes (national employee provident funds) to PAYG-based social insurance systems.

24. In addition to actuarial and financial reasons, pension fund reform in terms of the introduction of individual capitalization schemes has been driven by the consideration to use such schemes to raise savings and create additional institutional sources of finance for the strengthening of corporate capital and domestic capital markets. This would seem to be one of the objectives behind the Chilean reform introduced in 1981, which is regarded as the first privatization of State pension systems of its kind and which led to the pension funds playing an important role in the privatization and capitalization of a number of large-scale enterprises during the 1985-1988 privatization programme in Chile. France is reportedly preparing to introduce a private pension fund plan, as a complement to the State PAYG system, with the objective of mobilizing private savings for the bolstering of corporate capital and domestic capital markets and thus of facilitating the implementation of its ambitious privatization programme. 10/

25. The following sections will discuss a number of issues relating to the privatization of State pension systems, with particular reference to the Chilean experience. The Chilean reform is the first full-scale privatization of its kind, with more than 12 years of experience behind it and on which numerous studies have been made. The issues to be discussed include: the nature of the reform in Chile and its implications; competition and regulation: the effects of capitalization schemes on savings; and the role of financial and other reforms. 11/

B. Nature of the reform

26. Chile has opted for an individually capitalized system, based on mandatory contributions by employees only of 10 per cent of their base salaries which are paid into individually-owned pension accounts, until the age of 65 for men and 60 for women. The State guarantees, by means of a special contribution to individual pension accounts, a minimum pension,

currently about 85 per cent of the minimum wage, but only for those pension fund participants with at least twenty years of contributions to their accounts. (There is also a basic (safety net) pension provided by the State for those who are unable to accumulate funds for a pension, but the number of beneficiaries is limited to 300,000 per year.) Pensions, as well as invalidity and survivor's benefits and severance allowances (for which employees pay an additional contribution of 2.5 to 3.7 per cent of their salaries towards a group insurance policy), are separated from other components of social security. Family allowances and sickness, maternity, work injury and unemployment benefits are now covered under separate social security or insurance schemes sponsored by the Government but with different degrees of private sector involvement. The advantages claimed for such a separation is that it avoids the use of pension contributions for purposes other than the payment of pension benefits. Further, the reform avoids the need to revise periodically the contributions, as is needed in a defined benefits system in order to take account of demographic changes or the effects of the economic cycle on employment. It also shields the pension system from political interference.

27. However, whether the reform is justified in terms of cost efficiency or of its costs and benefits is a matter for further research. It may be noted, in this connection, that the issue of a separate system of individually capitalized pension accounts, which would seem to have a positive effect on savings, needs to be distinguished from that of the administration of the system. Such accounts can be administered by the State through a statutory body. It would thus seem appropriate to make a comparison not only with the old system but also with a publicly-administered individual capitalization scheme, particularly in terms of the administrative costs and of the rates of return on investments.

28. A comparison with the old PAYG system would have to take into account the risks of individual contributors which were previously assumed by the State or by means of mutual insurance or of inter-generational solidarity. Unlike the PAYG system, the current system does not contain elements of mutual insurance or of solidarity, for example between different social groups, between male and female employees or between generations. Such risks include inflation and investment risks, as reflected in real rates of return on investments (although such risks may be offset to the extent that shortfalls in minimum profitability can be covered by the reserve fund) and of retirement income falling below the poverty line for low-income workers. There are, in addition, the risks of mismanagement by the PFAs. Unlike the PAYG system, there are also complexities concerning the life expectancy of the contributor or of the surviving dependents which the contributor will have to cope with when deciding how to convert the accumulated funds into monthly pensions, since the system provides for those who qualify the choice of an indexed annuity, a programmed monthly pension by the PFA or the combination of a programmed pension and a deferred annuity. Contributors qualify when they reach the retirement age or when their accumulated funds are sufficient to permit early retirement, i.e. when such funds can provide a pension with a replacement rate, defined as a percentage of final earnings, of at least 50 per cent. Other things being equal, the use of gender-specific annuity tables would lead to a lower pension for women. Further, since employers do not contribute to the pension fund accounts, the issue of equity also arises.

29. The comparison would also have to take into account the administrative costs for the contributors. These include the commissions charged by Pension Fund Administrations (PFAs). The PFAs, 19 of them in 1992, act as financial agents or intermediaries of the pension accounts which are individually owned by the contributors. (The capitalized contributions are held by a separate entity called the Pension Fund.) The commissions, which vary between PFAs, consist of a flat rate and a rate that is proportional to contributions (2.5 to 3.5 per cent of insured earnings). They have dropped from an average of 5 per cent in 1983 to an average of 3.2 per cent in 1990. In this connection, the question has to be raised as to whether high marketing costs are making the commissions more expensive than they need to be. The administrative costs also include charges levied by insurance companies for converting lump-sum withdrawals into an indexed annuity. Further, because of the complexity of the options, contributors may feel obliged to use the services of an advisor (some 2,000 of them) to advise them on the choice, which would mean an additional cost.

30. In the final analysis, the success of the reforms will depend on the performance of the pension funds, as measured by the real rates of return on their investments and the level of benefits provided. The real rates of return averaged 15.4 per cent during the period 1981-1991, and 11.2 per cent during 1987-1992, with the rate falling to nearly zero in 1992. However, such rates may not be sustainable in the long run. As far as pension benefits are concerned, they depend on the contributions and their capitalization rate. Actuarial calculations indicate that, for men retiring at 65 and women at 60 after a full working life and contributing continuously 10 per cent of their earnings, an annual real rate of return of at least 5 per cent would be needed to secure a 100 per cent replacement rate. The rate would drop to 4 per cent for a 75 per cent replacement rate, 3 per cent for a 44 per cent replacement rate and so on. However, figures show that, while there were 4.1 million members affiliated to the new system in December 1991 (85.6 per cent of the total labour force), only 2.5 million of them (51.8 per cent of the total labour force) were contributors. This discrepancy may be explained by a number of factors such as loss of jobs, lack of incentives, late payment by employers of the employee contributions collected by them and a high proportion of independent, informal workers, together with a high incidence of poverty. All this raises the issue of what may be done in order to lock in the contributions. Unless that is done, the profile of contributors suggests that an important proportion of the members will end up with acquired benefits less than the guaranteed minimum. And the State would need to incur additional liabilities for those with a qualifying period of contributions.

31. It has been estimated that the average old-age pensions paid by the new system for fully paid-up contributions up to age 65 exceed the corresponding pensions under the old system by 40 per cent. However, only 1.1 per cent of the contributors, i.e. among those who have been transferred from the old system under very favourable conditions, have reached retirement age in 1990 and received such benefits. For this reason and for the reasons stated above concerning the contributions profile and the future evolution of real rates of return on investments, no general or firm conclusions can be drawn from this comparison.

32. The State continues to bear certain costs, including the cost of maintaining the old system for those who chose not to transfer to the new system (covering 8.5 per cent of the total labour force), providing "recognition bonds" to those who chose to transfer to the new system (with a capitalization rate of 4 per cent and a replacement rate of 80 per cent), and of guaranteeing a minimum pension for those with a qualifying period of contributions. The cost of the transitional measures is estimated at 4.8 per cent of GDP in 1992, although its share of GDP is projected to be halved by the year 2010. The continuing financial burden is having an important negative impact on health services. Further, to the extent that 50 per cent of the resources of insurance companies are invested in Government indexed bonds, the State bears also a part of the responsibility for the indexed annuities of the insurance companies. In the final analysis, the State must also assume any risk of failure of pension funds and of associated insurance companies. Just as in 1983, after the capital market crisis of 1982 had led to the bankruptcies of a number of newly privatized banks, the Government renationalized the banks (which were subsequently sold back to the private sector), it would be inconceivable that the Government would not come to the rescue of a failing PFA or insurance company. Even if the risk is minimal, because of the regulations governing their operations, the argument is still valid. In fact, the question may be asked as to whether the reform undertaken was privatization in the strict sense of a complete transfer of risks to the private sector. This being said, it is doubtful whether the transfer of risks in the context of the privatization of financial sectors, for political and social reasons, can ever be absolute.

C. Competition and regulation

33. Competition among the PFAs in terms of quality of service, commissions charged and rates of return on investments, is fostered by allowing contributors to switch freely from one PFA to another. There is no limit on foreign ownership, and the four largest PFAs are foreign-owned. However, the market is dominated by the three largest PFAs which between them currently control 67.5 per cent of the market, as against 73 per cent in 1981. This market domination by the three PFAs has raised the question as to whether some industrial reorganization may be needed.

34. The system is regulated by the Government, but mainly on the investment side. Contributors are protected through the establishment of diversification requirements, which are much stricter than those applied to investment or mutual funds, and of a risk classification system. The regulations ensure that: pension funds can only be invested in legally authorized financial instruments to be evaluated and approved by the National Risk Classification Commission; portfolio diversification is subject to limits on investments in instruments issued by the same sources and on the types of instruments to be held; the value of all pension fund instruments is adjusted daily in accordance with prices established by the supervisory authority and periodic reports are issued to contributors; a minimum return is earned on the pension fund investments (a mandatory reserve has been created, equal to 1 per cent of the Pension Fund, to meet any shortfalls in minimum profitability up to the 1 per cent coverage); and at least 90 per cent of the financial instruments of the pension funds are deposited with the Central Bank.

35. The Risk Classification Commission includes the representatives of the three supervisory agencies concerned - for the stock exchange, banks and PFAs - and of four PFAs. Initially, the Commission classified the risks of the financial instruments eligible for investment by the PFAs which determine the limits on the amount permitted for investment in each specific instrument. However, the task of the Commission has evolved to one of overseeing the classifications issued by the authorized private institutions.

D. Effects on savings

36. A major argument in favour of individually capitalized pension funds is that they have a positive effect on savings and on real capital formation. This argument has been made with respect to both the positive effect of such pension funds on personal savings and the negative effect of PAYG systems on such savings. The argument in respect of the former is that individuals are myopic concerning their old-age security needs and that a system of capitalization of compulsory savings retained in individually owned pension accounts can help to increase personal savings. (The argument would seem to apply also to collectively capitalized pension funds, as in the Netherlands.) Further, there is evidence, for example from the ECLAC case studies 12/, that the response of voluntary savings to interest rates is poor. Moreover, higher interest rates affect corporate savings negatively, as firms are net borrowers.

37. The other part of the argument concerns the effects of PAYG systems on personal savings. Two reasons have been given in this connection. The first is that such systems, when they were first created, have tended to provide over-generous defined benefits in relation to the contributions and that this has tended to increase consumption spending 13/. The second reason given is that such systems, by guaranteeing old-age security, have a disincentive effect on personal savings 14/.

38. Studies in the United States have shown that pension savings tend to reduce non-pension savings. However, each pension dollar saved tends to reduce non-pension savings by only about 65 cents, so that there is a net increase in savings. Given that preferential tax treatment for private pensions may lower non-pension savings, the net effect may fall to 20 cents to the dollar, assuming that the Government does not raise taxes elsewhere to provide offsetting revenue for the tax breaks 15/.

39. Pension savings in Chile have increased from 1.7 per cent of GDP in 1983 to 3.3 per cent of GDP in 1991. However, other forms of private savings have also increased significantly during the period, from 8.2 per cent of GDP in 1983 to 10.9 per cent of GDP in 1991, lifting total private savings from 9.9 per cent of GDP in 1983 to 14.3 per cent of GDP in 1991. Thus, the share of pension savings in total private savings has increased from 17 per cent in 1983 to 23 per cent in 1991. Aggregate public and private savings have also increased, accounting for 19.2 per cent of GDP in 1991, compared to 7.8 per cent in 1981 and 5.4 per cent in 1983 (following the sharp recession in 1982). However, it is felt that further research is needed before any firm conclusions can be drawn regarding the effect of the reform on aggregate savings. This is because the public sector social security deficit related to the reform, which has a direct effect on public sector savings, is

still affected by the transition from the old pension system to the new one. Further, while pension savings have increased, so have other forms of private savings. And the effects of the reform cannot be easily isolated from those of other factors, including changes in income distribution and in the composition of savings, financial liberalization, balance of payments deregulation and labour market reforms.

E. Financial and other reforms

40. It is worth noting that the pension fund reforms were introduced after other reform measures had been taken to liberalize financial markets, including interest rates, to strengthen public finance through a major reform of the fiscal regime and to reduce inflation. The significant fiscal surplus achieved in 1980 as a result of the reforms made it possible to finance a major part of the fiscal outlay associated with the first phase of the pension fund reform. The liberalization and strengthening of the financial sector made it possible to expect adequate rates of return on investments and a wider spread of financial instruments for the PFAs to diversify their portfolios and reduce risk. Macroeconomic stability also meant that the financial sector could count on long-term investment returns.

41. The capitalized pension funds expanded at an average real annual growth rate of 47.1 per cent from US$ 220 million in 1981 to US$ 10 billion in 1991. At first, investments were concentrated on public debt instruments. This investment policy helped to instil confidence in the system, to alleviate the Government's cash flow problem caused by the reform and to give time to the capital markets, which at the time did not offer many options, to develop. Thus, fortuitously the pension funds were spared the effects of the stock market crash of 1982. The change in policy in 1985 to allow the pension funds to invest in corporate equity coincided with the launching of an ambitious privatization programme involving the privatization of a number of large-scale enterprises. The participation of the pension funds as domestic institutional investors contributed not only to the successful privatization and capitalization of the enterprises but also to the increased capitalization and deepening of the financial markets. The pension funds also helped to generate political support for the large-scale privatizations, including telecommunications, coal and pharmaceutical companies, by showing that they did not only benefit large foreign corporations.

42. As of June 1992, the portfolio composition of the pension funds were as follows: Government securities - 37 per cent; bank deposits and bonds - 10; mortgage securities - 13; company bonds and debentures - 12; and common stocks - 28 per cent. (By comparison, pension fund investments in corporate equities are much higher in the United Kingdom and the United States (70 per cent and 53 per cent respectively in 1989), and less in Japan and the Netherlands (about 15 per cent).) Since PFAs control vast amounts of funds as institutional investors, there is the issue of their influence on corporate governance. Some proposals are still under consideration which would limit their power in electing the board of directors of a company, with opinion being divided on the matter. Those who oppose further regulation believe that the current regulations are sufficient and that the PFAs, in defence of their clients' interests, have every reason to act in the best interest of investors.

43. The rapid growth of the pension funds, from 0.9 per cent of GDP in 1981 to 34.4 per cent of GDP in 1991, has been helped by large inflows of foreign investment, coupled with a significant currency appreciation, strong economic growth of an average annual rate of 6 per cent and a five-fold increase in the real price index of shares during the last seven years. The pension funds are projected to level out at slightly above 100 per cent of GDP by the year 2020. How the domestic capital markets are going to cope, whether they will provide the necessary investment outlets, whether the pension funds will be allowed to diversify further their investments and how all this will affect the rates of return on their investments are questions that need to be posed. Much will depend on the evolution of the economy. The restriction imposed earlier on the PFAs investing overseas has now been partially lifted. How that will affect their investments abroad and how those overseas investments will affect future macroeconomic performance remain to be seen.

F. Concluding observations

44. Pension fund reform is a complex issue. It raises questions which affect the very foundations of the organization of social security. Issues of mutual insurance against the risks of old age, invalidity and death, a social safety net, private provision against such risks, equity and intra- and inter-generational solidarity are involved. Also involved are the costs and benefits of a basic change, including that of the transitional arrangement, which can affect not only the present but also future generations. Improvements in the administration and management of the system can help but they may not be enough. Sometimes, the design and structure of the system itself is to blame. But there are limits to a major overhaul. For example, in Italy it has been estimated that it would require close to a 50 per cent contribution from salaries to balance contributions and payments within 30 years 16/. Thus, there are no easy answers. Not only do conditions differ from one country to another, but both the two basic systems - the defined-benefits collective PAYG-based social insurance and defined-contributions individually capitalized systems - have their own weaknesses. The former has elements of social solidarity, but requires frequent adjustments and may have disincentive effects on savings. The latter promotes savings but has limited population and contingency coverage.

45. There are also many different options in relation to the objectives to be achieved. If the objectives are to provide a minimum pension and a funded system to provide benefits related to earnings - broadly the aims behind the Chilean reform - a number of options are possible. (1) The minimum pension may be universal or subject to a means test. (2) The funded system may be a defined-benefits partially funded or a defined-contributions fully funded one. (3) Fully funded schemes may be voluntary or mandatory. (4) Such schemes may be based on individual or collective capitalization. (5) Funding may be based on contributions by both employers and employees, employers only or employees only. (6) The system may be State-administered or privately managed or may involve combinations of the two.

46. Chile has chosen a privately-managed fully funded system which combines a State safety-net pension limited to a quota of 300,000 beneficiaries, a State-guaranteed minimum pension related to contributions (with a qualifying period of 20 years) and a fully funded scheme based on mandatory contributions

by employees only. By comparison, New Zealand has a very simple system which provides a basic (safety net) pension to all those who qualify. Capitalization of savings is left to private initiative in a savings market that is supervised but not regulated by the State. The ILO has proposed a three-tier system as the most suitable one to meet the basic objectives of pension systems, namely a basic tier providing a fixed-rate minimum pension on a universal or means-tested basis, financed by taxation; a mandatory defined-benefits tier, financed mainly through contributions and operating on a partially-funded basis; and a voluntary complementary defined-contributions tier, based on individual or collective private initiative and operating on a fully funded basis. The second tier may be operated as a "scaled-premium" system, where "equilibrium periods" ranging from 5 to 10 years are defined and where a constant "equilibrium contribution" is calculated for the current period in order to guarantee the actuarial liabilities for that period and to accumulate a reserve for future "equilibrium periods". Since the technical reserves accumulate constantly, the system can have a positive effect on savings. Such a system may be particularly suitable for countries where the economic and demographic evolution has not yet stabilized.

47. The Chilean reform has also been conceived as a means of raising savings, and the figures suggest that it has helped to mobilize savings and accumulate capital. However, the full-scale privatization route or the elaborate system chosen is not the only option. France is reportedly to launch a private pension fund plan for the same purpose, but as a complement to and not as a substitute for the PAYG system. Thus, other than State-administered individually capitalized pension systems, as in Indonesia and Malaysia, a State run partially funded system can be combined with a privately managed fully funded one. Another option still is a State run (second-tier) "scaled-premium" system, combined with private management of its technical reserves. Separate management of the reserves, whether privatized or not, which needs to be properly regulated, would have the advantage of ensuring that the reserves are not used for other purposes, for example the financing of fiscal deficits.

48. The privatization of a pension system raises major issues of political, economic and social significance and cannot be treated in the same way as the privatization of an industrial or trading enterprise. Further, as indicated above, there are other options to full-scale privatization. In any case, even allowing for the fact that the Chilean pension fund reform has achieved its objectives, for example in contributing to the mobilization of savings and capital formation, it does not follow that it can be transplanted elsewhere. The ex ante and ex post conditions in which the Chilean reform was implemented, including well-established financial markets, must be kept in mind. Further, such a sweeping measure will need a full social dialogue and negotiation if it is to be implemented in favourable conditions.

Notes

1/ See "Privatization and the environment: a survey of the main issues with particular focus on developing countries" (TD/B/WG.3/Misc.39), November 1993.

2/ See also Privatization: The Lessons of Experience, World Bank, 1992.

3/ See "The effect of the internalization of external costs on sustainable development" (TD/B/40(2):6), January 1994.

4/ See 2 above.

5/ D. Wheeler: "Enterprise ownership and pollution" (draft) World Bank discussion paper, 1993.

6/ International Herald Tribune, 29 December 1993.

7/ For a discussion on some of the issues related to property rights (i.e. State vs. private ownership) see, for example, "Fostering sustainable development in the commodities field, experiences concerning environmental effects of commodities production and processing: synthesis of case studies on cocoa, coffee and rice", report by the UNCTAD secretariat (TD/CN.1/15), 22 September 1992; "Fostering sustainable development: mineral resources and sustainable development", report by the UNCTAD secretariat (TD/B/CN.1/16), 27 September 1992; "The links between market conditions, intensity of resource use and environmental impact: the case of mining", I.M. McKendry (UNCTAD/COM/11), 16 September 1992.

8/ In Thailand, the establishment of secure land titles, the cost of which was only around 10 per cent of the potential benefits proved to improve significantly the environmental management of the resources involved at an acceptable price. See Panayotou, T. (1993) quoted in TD/B/40(2), .. January 1994 (item 3 above).

9/ See Infrastructure policies for the 1990s, OECD, 1993.

10/ International Herald Tribune, 30 December 1993.

11/ For general references on the Chilean experience, see inter alia articles by: Mr. Andras W. Uthoff, based on case studies undertaken under various UNDP/ECLAC projects and entitled "Pension system reforms and savings in Latin American and Caribbean countries with special reference to Chile", published in an ECLAC/UNCTAD/UNU/WIDER publication entitled Finance and the Real Economy, Santiago, September 1993; Messrs. Colin Gillion and Alejandro Bonilla entitled "Analysis of a national private pension scheme: The case of Chile", International Labour Review, vol. 131, 1992, No. 2; and Mr. Luis A. Larrain, "A bold step in Chile's reforms: privatization of the pension system", Economic Reform Today, Spring 1993.

12/ Uthoff, 1993: See 2 above.

13/ Feldstein, "Social security, induced retirement and aggregate capital accumulation", Journal of Political Economy, vol. 82, No. 5, September-October 1974.

14/ Hubbard, "Uncertain lifetimes, pensions and individual saving", Issues in Pension Economics", University of Chicago Press, Chicago, 1987.

15/ Munnell, The Economics of Private Pensions, Brookings Institution, Washington, D.C., 1982.

16/ Financial Times, 31 December 1993.